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Canada- United States Relations

VOLUME 1

**The Institutional Framework
For the Relationship**

THE STANDING SENATE COMMITTEE ON FOREIGN AFFAIRS

Chairman: The Honourable George C. van Roggen

Deputy Chairman: The Honourable Allister Grosart

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December 1975

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MEMBERSHIP OF THE COMMITTEE

(As of December 16, 1975)

THE STANDING SENATE COMMITTEE ON FOREIGN AFFAIRS

The Honourable George C. van Roggen, *Chairman*

The Honourable Allister Grosart, *Deputy Chairman*

and

The Honourable Senators:

Asselin	Croll	McElman
Barrow	Hastings	McNamara
Bélisle	Lafond	Rowe
Cameron	Laird	Sparrow
Carter	Macnaughton	Yuzyk
Connolly (<i>Ottawa West</i>)		

Ex Officio Members: Flynn and Perrault.

(Quorum 5)

Note: The Honourable John B. Aird served as Chairman of the Committee during its initial meetings on Canada-United States Relations from March until May 1974. Following his resignation from the Senate, the Honourable George C. van Roggen was appointed Chairman of the Committee.

Note: The Honourable Senators Aird, Deschatelets, Lapointe and Martin also served on the Committee.

ORDERS OF REFERENCE

(Second Session—29th Parliament, 1974)

Extract from the Minutes of the Proceedings of the Senate, Tuesday, March 26, 1974:

The Honourable Senator Aird moved, seconded by the Honourable Senator Grosart:

That the Standing Senate Committee on Foreign Affairs be authorized to examine and report upon Canadian relations with the United States; and

That the Committee be empowered to engage the services of such counsel and technical, clerical and other personnel as may be required for the purpose of the said examination, at such rates of remuneration and reimbursement as the Committee may determine, and to compensate witnesses by reimbursement of travelling and living expenses, if required, in such amount as the Committee may determine.

After debate, and—

The question being put on the motion, it was—

Resolved in the affirmative.

Robert Fortier,
Clerk of the Senate.

* * * * *

(First Session—30th Parliament, 1974-1976)

Extract from the Minutes of the Proceedings of the Senate, Wednesday, November 6, 1974:

Pursuant to the Order of the Day, the Senate resumed the debate on the motion of the Honourable Senator van Roggen, seconded by the Honourable Senator Riel:

That the Standing Senate Committee on Foreign Affairs be authorized to examine and report upon Canadian relations with the United States;

That the Committee be empowered to engage the services of such counsel and technical, clerical and other personnel as may be required for the purpose of the said examination, at such rates of remuneration and reimbursement as the

Committee may determine, and to compensate witnesses by reimbursement of travelling and living expenses, if required, in such amount as the Committee may determine;

That the papers and evidence received and taken on the subject in the preceding session be referred to the Committee; and

That the Committee have power to sit during adjournments of the Senate.

After debate, and—

The question being put on the motion, it was—

Resolved in the affirmative.

Robert Fortier,
Clerk of the Senate.

REPORT
of the
STANDING SENATE COMMITTEE ON FOREIGN AFFAIRS
on
CANADA-UNITED STATES RELATIONS
VOLUME I

“The Institutional Framework for the Relationship”

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Acknowledgements

In the preparation of this report, the first in a series on Canadian-American relations, the Committee owes a debt of gratitude to the witnesses, both Canadian and American, who kindly consented to give the Committee their time and the benefit of their expertise on various aspects of the study. These witnesses included both present and former Cabinet ministers, a provincial premier and a former state governor, former senior Canadian and United States officials, representatives from the private sector, academia and from the Canadian federal public service. For their willing co-operation we are most grateful.

I wish to record my thanks to all members of the Committee, my special appreciation for the support and advice of the deputy chairman, Senator Allister Grosart, and to acknowledge the valuable assistance of all members of the Committee staff.

An index of the proceedings of the Committee during 1974 and 1975 on which this report is based has been prepared by the Reference Branch, Library of Parliament. This index is available on request from the Clerk of the Committee.

George C. van Roggen

Part I

A. Introduction

The Standing Senate Committee on Foreign Affairs has undertaken to examine and report on Canadian relations with the United States. The purpose of this preliminary report is to put into proper perspective the basic framework by which the Canadian-American relationship functions. Before examining substantive areas such as Canada-United States trade, energy, transportation, communications, labour, financial and environmental relations, the Committee considered it necessary to identify the main institutional links, to assess their effectiveness as channels of communication, and to look at the efficacy of various techniques available for the conduct of the bilateral relationship. This report deals only with the institutional framework between the two countries.

Such mechanisms between any two modern states in close contact are likely to be complex. They are particularly so between two large federal democratic states existing side by side. They are usually taken for granted, apparently on the assumption that they function automatically. This is not the case. There are judgments to be made as to how issues should be handled and who should handle them which can have a major influence on the outcome of bilateral problems.

Accordingly, the Committee concluded that a thorough look at this aspect of the relationship was not only justified but was fundamental to future studies in this area. Moreover it considered that it behoved Canada, as the more vulnerable member of the North American arrangement, to ensure that the relationship did not suffer from inefficient communication or management on its part.

With this in mind the Committee heard expert witnesses from the federal and provincial governments, from the academic community, from the private sector, from Canada as well as from the United States.* They gave testimony on all aspects of the functioning of the relationship; the types and levels of the bilateral contacts, the joint mechanisms, the methods and machinery used for interdepartmental co-ordination, for bilateral consultation and for bilateral negotiations, the involvement of the provinces and the role of the private sector.

Because the Committee's objective was to identify the existing links and to assess the suitability of alternative procedures used in conducting relations, this report does not suggest a simplistic solution for the better management of all aspects of the relationship. Each situation usually has its own set of circumstances and the techniques used must be modified accordingly. For these reasons, the report has

*See Appendix II to this Report, page 87, for a list of witnesses.

sought to give sharper focus to the problems and constraints as well as the possibilities and opportunities in managing Canadian-American relations. Where the Committee found it possible to reach firm conclusions, it has done so and has made specific recommendations to remedy areas where it found deficiencies.

This report deals mainly with government-to-government contacts. It is important to recognize however that this is not the whole picture but only the tip of an iceberg. In the private sector, financial, business and private transactions are not statistically visible but number millions per month by telephone and mail alone, not to mention the enormously high number of daily border crossings. This interchange goes on largely independent of and beyond the control of governments. It is one of the basic strengths of the relationship. The Committee has sought to take this significant factor into account wherever possible, although it found it difficult to obtain specific testimony on its magnitude.

The dimensions and complexities of the links between our two countries can best be understood when set against the following brief survey of the range and scope of the relationship. In addition, the Committee has commented in general terms on the present character of the relationship which has undergone some change in recent years and sets forth some current problems.

B. The Range and Scope of the Relationship

Geography has imposed unique constraints and presented opportunities which affect the relationship between Canada and the United States. The two countries divide most of the continent and are isolated from other land masses by three oceans. They have a long common border and a number of contiguous coastal waters. Canada has a common frontier with only one country, the United States. It is on two fronts: to the south stretching along 3,500 miles; and to the northwest, the 1,500 mile long border with Alaska. Geography too, by its north-south land formations, has channelled the movements of people north and south across the border creating many close cross-boundary regional affinities. Climate and geography have combined to concentrate two-thirds of the Canadian population in a 100 mile-wide band of territory facing the American border predisposing them to a conscious awareness of the United States.

The history of the exploration and development of the two countries records frequent disagreement and open conflict. This has not prevented a parallel evolution in social, economic and, in most respects, political and judicial structures. In education and culture, Canada and the United States are fundamentally alike though Canada is a bilingual country. Ideas and cultural influences flow easily across the border. More important, the structures and institutions on both sides are mutually understandable. Significant differences, however, have emerged from the varied historical and social backgrounds which have produced distinctive identities in the two nations.

These geographic pulls and social and institutional parallels have meant easy movements and contacts back and forth by the peoples of the two countries. Family ties have rapidly multiplied, business and labour links have developed, professional and fraternal affiliations have grown and cultural, sport and tourist connections have become abundant. While measurement of these private linkages is almost impossible, in terms of numbers, cross-border visits now reach over 70 million annually of which 38 million are from the United States to Canada and 34 million from Canada to the United States. For Canada, with its much smaller population, this means that an enormously high concentration (96 percent) of all its people going outside the country choose to go to the United States. Some of the trans-border crossings have become permanent. At the present time, the Committee learned, it is estimated that approximately a million Canadian-born persons are living in the United States and about 400,000 American-born persons are living in Canada.¹

Due to geography, history, the mingling of the two peoples and other factors, trade between the two countries has grown enormously. In 1974, cross-border trade reached the dizzying heights of \$40 billion—more than between any two other countries in the world.

Canadian Trade with the United States

	Exports		Imports	
	(In \$ million)	% distribution		% distribution
1970	10,900	64.8	9,917	71.1
1971	12,025	67.5	10,951	70.1
1972	13,926	69.4	12,877	69.0
1973	16,612	67.7	16,484	70.8
1974	21,590	66.5	21,065	67.3
1975 (9 mos.)	15,798		17,476	

For Canada, this means a market for over two-thirds of its exports, representing over one-third of all goods produced in Canada. For the United States, Canada constitutes one-fifth of its export market but this involves only two percent of all American-produced goods. The United States supplies two-thirds of all goods imported into Canada and Canada supplies one-quarter of all imports into the

¹Arthur Smith (3:46)

Footnotes referring to Committee proceedings indicate the issue and page number of its proceedings of the first session of the 30th Parliament, 1974-75. Three exceptions which refer to an earlier session of 1974 are specifically identified by *Session 1974*

United States. Over one-half of Canadian exports to the United States are manufactured or processed goods, although two-thirds of these are automotive products.

The scale of the trading relationship can best be appreciated by comparing United States trade with other countries. Japan, which is the United States second largest partner, does about one half the trade with the United States that Canada does. American trade with all nine countries of the European Community, a group encompassing a population 10 times that of Canada, amounted in 1974 to slightly less than its trade with Canada alone. As the former American Ambassador to Canada, Mr. William Porter, said in a recent speech;

"The Canadian-U.S. trade exchange, like other aspects of our relationship, remains the wonder and envy of a large part of the world. There is nothing like it in dimension or variety."²

While the Canada-United States ties in other areas may not be as striking as these in the trade field, they are nonetheless important and complex. As the Committee heard from Mr. Alan Hockin, vice-president of the Toronto-Dominion Bank, the financial ties between Canada and the United States are "extensive and close; much more so than between Canada and any other country."³ This "close and pervasive linkage" he explained, arose not only from transactions of a purely financial nature such as the large borrowings and investments flows in both directions, but more importantly from the sheer volume of the bilateral export and import trade and the trade in services such as insurance, transportation and tourist trade. In addition, the link between the currencies is intensified for Canada since Canadian exports to other parts of the world are largely conducted through the medium of U.S. dollars.

Cross-border investment has provided an extensive and frequently controversial link between Canada and the United States. The book value of American direct investment in Canada now approaches \$30 billion while the real value is estimated at \$50 billion. This represents 80 percent of all foreign investment in Canada. As U.S. investment has come mainly in equity form, American control of Canadian industry is widespread. Well over half the Canadian manufacturing industry is now foreign controlled, mostly by Americans. In certain key sectors such as petroleum refineries, iron mining and certain machinery and electrical industries, the U.S. control is over 70 percent and in the motor vehicle industry it is over 95 percent.

Canadian investment in the United States, by comparison, is a more modest \$5.6 billion, although on a *per capita* basis, statistics show a higher rate of Canadian investment in the United States than the reverse. But most Canadian investment in United States equity is in relatively small holdings, so that there are few cases of Canadians owning a controlling interest in American corporations.

The traditional balance of payments situation between the two countries shows a continuing Canadian deficit position. (See table below). Even in the exceptional

²Winnipeg, CHA, September 25, 1974

³Hockin (15:5)

years 1970-1972 when Canada had a merchandise trade surplus with the United States, its overall current account remained in deficit due to the substantial deficit in services which Canada always suffers.

In merchandise trade, Canada's surplus position of 1969-1972 has steadily decreased until it reached a low in 1974 of \$53 million. Even so, it was only the large gains in the value of export of energy and petroleum products sold to the United States which erased a huge deficit of \$1.3 billion on automotive products and prevented an overall merchandise trade deficit.

Canada's Current Account Balance with the United States
(\$ million)

	Merchandise trade balance	Non-merchandise transactions ⁴ .	Current account balance
1969	472	— 1,317	— 845
1970	1,121	— 1,286	— 165
1971	1,209	— 1,491	— 282
1972	1,233	— 1,687	— 454
1973	814	— 2,071	— 1,257
1974	525	— 1,737	— 1,812
1975 (6 mos)	— 843	— 768	— 1,611

In the labour field, the close relationship existing between the trade union movements in Canada and the United States is without parallel anywhere in the world. About 60 percent of unionized Canadian workers belong to unions chartered by U.S.-based 'international' unions. Practically all of Canada's major export industries including the large industries in both primary and secondary sectors such as automobiles, steel and chemicals are governed by the terms of collective agreements with Canadian branches of U.S. affiliated unions. It is these major industry unions, however, that have tended to give the Canadian membership the widest scope for running their own affairs particularly in respect to such aspects as control over union expenditures in Canada and their own collective bargaining programme.

The current criticism aroused by Canada's oil export tax and higher gas prices to the United States has obscured the more important fact of the major linkages between the two countries in the energy field. Canada has been the largest foreign

⁴Includes service transactions, travel, interest & dividends, freight & shipping and other service transactions plus net transfers.

supplier of oil to the United States with exports reaching their peak of over one million barrels of crude daily in 1972. At its height this represented 29 per cent of U.S. crude oil imports. However, the Canadian percentage of U.S. crude oil imports has been falling owing to the cuts in Canadian deliveries and to the increasing dependency of the United States on imported oil.

For obvious reasons, virtually all United States imports of natural gas have come from Canada although this will change with the facilities for liquefying gas. While the approximately one trillion cubic feet which Canada has supplied during the past couple of years represents only about five percent of American consumption, it has amounted to more than 45 percent of total Canadian production.

The energy interdependency is underlined when one considers that Ontario steel mills and electric generating plants are dependent on Pennsylvanian coal, and Canadian refineries require the oil piped through transit pipelines in Maine and the American midwest. In the United States, the Pacific North-west area depends heavily on British Columbia natural gas and several northern states in the American mid-west have no source other than Alberta for natural gas and oil. At various other points along the border, a constant interchange of hydro-electric power takes place.

In the defence area, Canada has recognized, since World War II, its strategic dependence on its superpower neighbour in respect to external threats. Canadian defence arrangements with the United States are intimate and extensive. Indeed, a third of the major bilateral agreements with the United States relate to defence. The most important of these is the NORAD agreement which provides for close coordination of air defence of the continent—a response to a threat which is diminishing with the increasing Soviet and American emphasis on missiles. Defence co-operation began in 1940 with the establishment of the Permanent Joint Board on Defence. The principle of economic co-operation to support joint defence was enunciated in the Hyde Park Agreement of 1941 and it has been reaffirmed in varying forms since that time. The current defence production sharing arrangements worked out in 1959, have resulted in extensive reciprocal military purchases bringing mutual benefit in terms of reduced costs for military procurement, in keeping Canada abreast of advanced technology in aerospace and electronics and in providing the Canadian electronics industry with a significant outlet.

Much has been written about the cultural interaction between the two countries, particularly the impact of American culture in all its forms on Canada. Books, magazines, newspapers, radio, T.V., movies and theatre pour northward across the border to a ready Canadian market. A 1974 survey showed that over one-fifth of all television viewing hours by Canadians are devoted to American stations, either off-air or by cable. An earlier survey of audience preference revealed that 54 per cent of Canadians preferred American T.V. stations to Canadian stations and 60 per cent preferred American programmes to Canadian programmes. By its massiveness, the American cultural flood has threatened the development of the home-grown Canadian product leading to Canadian federal support or statutory and regulatory

protection in certain fields. Nevertheless, the American penetration has resulted in a widespread acceptance in Canada of American tastes, standards and products, a development viewed by some Canadians as a mixed blessing.

Geography has imposed an environmental interdependence on the two countries which is unique. From the Skagit and the Columbia in the west to the St. John and the St. Croix in the east stretches the most complicated and longest river and lake system between any two countries in the world. Environmental concern over pollution and floods in these rivers and lakes inevitably spreads across the boundary. Protracted bilateral negotiations now take place over the damming, the direction, the quality and the usage of this lakes and rivers system. Key to the resolution of many of these problems has been the work of the oldest Canadian-American institution, the International Joint Commission. In addition, the contiguous coastal waters are increasingly the focus of the external policies of the two countries in their concern for fisheries, pollution and mineral resources in the continental shelf areas.

This brief catalogue of the range and scope of the relationship between Canada and the United States is far from complete. Even so it illustrates the unusually high degree of interaction and interdependence between the two countries. It is not a relationship of equals. The United States has 10 times the population and over 10 times the gross national product of Canada. In military terms it is a superpower, in economic terms a giant. **Because of this disparity, Canada is more dependent, more sensitive and more vulnerable to the state of the relationship than is the United States. For Canada, it is by far the most important of all its external relationships.**

C. The Changing Concept of the Relationship

In recent years the Canadian-American relationship has undergone a change, due partly to external and partly to internal factors. Dating from 1970 and most certainly from August 1971 a new perception of each country's national interests developed, accompanied by an increasing divergence of national policies. Both countries reviewed their foreign policies and discovered they were at the end of an era, not merely in so far as each other was concerned but in the context of a changing world order. In an international climate of growing economic blocs and increasing economic and monetary ills, both countries were inclined to guard their own domestic health more protectively. The good relations of the past could no longer be taken for granted.

In practice this has meant that while Canada and the United States acknowledged the benefits derived from their huge bilateral trade, there was a new sharper edge to Canadian-American negotiating on trade and economic matters. As recognition of the finite quantities of resources grew, new conflicts and tough bargaining arose from bilateral energy trade arrangements and any suggestions of continental resource sharing caused extremely negative Canadian reactions. Increased environmental concerns have sensitized both sides to irritants along the border and the

contiguous coastal areas. On both sides of the border, but at different times since 1970, there has been a viewpoint that special bilateral arrangements such as the auto pact, while bringing many benefits, have also produced unexpected dislocations. Canadians have worried about and have now legislated against the high degree of foreign, mostly American, ownership and control of their manufacturing and resource industries as well as the continued extraterritorial application of U.S. laws and regulations in Canada.

In Canada, while these perceptions were working themselves out, the government formulated a new strategy paper for its relations with the United States. Known as 'the third option' paper, it set Canadian policy on a conscious course of attempting to lessen the vulnerability of its economy from the impact of the United States by developing closer relations with other parts of the world, notably Europe and Japan. The government's prospects and possibilities for diversification, however, were somewhat dimmed by the heavy impact which the energy crisis and inflation have had on the European Community and Japan, as well as on Canada itself.

The "third option" paper set a new tone for Canadian policy "of living distinct from but in harmony with the United States"⁵, which, when coupled with Canadian policy initiatives based on domestic needs and the new perceptions of the national interest on both sides of the border, has resulted in a perceptible change in the relationship. Whereas, in earlier days, bilateral relations had hinged to a large extent on the actions of the United States, now the relationship is increasingly affected by Canadian policy actions, many of which are perceived in the United States as being contrary to United States' interests. Prime examples of such Canadian actions are related to the price and supply of energy, the restrictions on foreign investment, the regulation of TV and cablevision programming of US origin and non-tariff barriers in cultural and other areas.

Have the changing circumstances and the new perceptions meant an end to the "special relationship" between the two countries? The problem has been to analyze what the "special" quality really meant. No incident provided a better illustration of the demise of one aspect of the "specialness" than the events surrounding the American government's refusal of the Canadian request for exemption from the 1971 American economic measures. As seen from Washington's point of view, Canada had contributed seriously to the American balance of payments deficit and had not been willing to help at a time of need. As seen from Ottawa, Canada had not been guilty, as the United States claimed, of unfair exchange rates or discriminatory restrictions against American imports. Canada was being unjustly penalized just because of a favourable merchandise trade balance, which was, in any case, more than offset by the debit on services and invisibles so that the overall current account showed a Canadian deficit. When the issue had cooled, Canada recognized that preferential treatment such as it had sought and received in the post-war period

⁵Sharp, (1:9) session 1974

would become a lessening factor in negotiations between the two nations. Washington considered that special accommodation for Canada was no longer justified and proceeded to demand a demonstrable equality of benefit from the bargaining table.

Witnesses before the Committee have pointed out however that there are other aspects of the special relationship which remain. Dr. Maxwell Cohen, Chairman of the International Joint Commission observed “the common frontier is a geophysical fact, a ‘special relationship’ however we interpret that phrase today.”⁶ Indeed, as has already been noted, the long and complex physical boundary unites the two nations in common solutions to problems concerning water quality, water levels, air quality and related land use problems. Professor Peyton Lyon of Carleton University pointed to the many existing structures, institutions and arrangements which tie the two countries together in a special way. As this report has already detailed, the range and scope of the bilateral contacts in trade, energy, financial institutions, cultural interactions are enormous, complex and undoubtedly “special” in the sense of “unique”. There is also the special quality of the relationship which exists between the two peoples because they live on the same continent, share much the same type of climate, similar democratic institutions, similar life-styles, similar means of communications and similar ways of doing business.

Finally, as Professor Lyon observed, there is a third aspect to the special relationship which is perhaps the most important of all. It concerns the procedures or the style of conducting official business between Americans and Canadians. Professor Lyon elaborated:

“ ‘Special’ in this sense means easy, informal, extensive, responsive and in short friendly; on both sides the masses still refer each to the other country as ‘our best friend’ and act accordingly.”⁷

It means easy communication through a common language and common values. There is a strong disposition to regard interests as compatible, to consult over differences and to let facts resolve the issues wherever possible.

How, the Committee asks, in the light of the geographic ties, the affinities and interchange of the two peoples, the ease of communications, the similar institutions, and the extent of trade, cultural and other links can the relationship be considered anything but a “unique” one? Canada no longer seeks a “special treatment”, but it cannot deny a “special relationship” does exist with its southern neighbour.

D. Current Problems

Because of the intense interaction between the two countries already described, an enormous number of bilateral issues are constantly developing which must be

⁶Cohen, (6:22)

⁷Lyon, (9:6)

dealt with at the inter-governmental level. Some are resolved easily and amicably. Others become dormant or solve themselves. Some become problems which require careful negotiating or tough bargaining to resolve. Still others prove insoluble and become problems which both countries must learn to live with.

The international economic climate is becoming more and more complicated and at times competitive. A growing number of Canadian domestic actions are having a spill-over effect on the United States and vice versa. The problem areas between the two countries continue to increase both in number and complexity.

Not all the complaints are on the Canadian side as many Canadians seem to think. Some of the areas of difficulty or concern for one side or the other in recent years include:

(i) *Energy Concerns*

- (a) Complaints by the United States that Canadians are charging more for exported natural gas than is charged on the Canadian domestic market.
- (b) American objections that, on the west coast, where there has been an unanticipated shortage in the British Columbia natural gas supply, the shortfall has not been prorated amongst the Canadian and U.S. consumers with long term contracts but has been passed on instead to U.S. consumers only.
- (c) American complaints concerning the Canadian export tax on oil which results in the United States being charged more for oil than is charged on the Canadian domestic market.
- (d) American objections concerning the rapidity and scale of the cutbacks in oil exports to the United States.
- (e) Canadian objections to the U.S. embargo against the importation of uranium, including Canadian uranium, into the United States.

(ii) *Trade Concerns*

- (a) American objections to the Canada-U.S. Automotive Agreement or to the Canadian safeguard clauses in that agreement. Canadian objections to the current unfavourable trade balance under the pact particularly involving auto parts.
- (b) A broad range of industry incentives as employed by both countries which the other country perceives as giving the industry concerned an unfair competitive advantage in respect to exports. Examples would include the U.S. Domestic International Sales Corporation (D.I.S.C.) or Canadian regional development programmes.
- (c) A variety of policies, legislations, regulations or practices of both countries which are perceived by the other side as being non-tariff barriers, that is, having the effect of restraining imports. Examples would include government procurement policies or quantitative restrictions.

(d) Beef import quotas which have recently been applied by both sides after many years of free access.⁸

(e) Canadian import quotas for eggs and turkeys on which the United States is appealing to GATT for a ruling.⁸

(f) Canadian complaints over the U.S. copyright law which effectively prevents the Canadian book industry from competing in the United States.

(g) Canadian objections to the application of U.S. anti-dumping regulations and the imposition of countervailing duties, for example, against the export of Canadian tires made by a Michelin subsidiary company.

(iii) *Environmental Concerns*

(a) Canadian concern over the pollution risks from tankers bringing Alaskan oil into Puget Sound in the State of Washington. Canadian objections to the establishment of a refinery by a U.S. oil company in Eastport, Maine which would require tankers to pass through constricted Canadian waters.

(b) Canadian concern that the United States is not meeting the commitments it made under the Great Lakes Water Quality Agreement to clean up the Great Lakes.

(c) Differences of opinion on both sides concerning effective regulation of water levels of the Great Lakes.

(d) Differences as to how to meet the present and future needs of the inhabitants, both Americans and Canadians, of Point Roberts in the State of Washington in respect to roads, water supplies, services, sewage etc.

(e) Differences over whether to proceed with an earlier British Columbia commitment to allow the provision of more power to Seattle, in the State of Washington by raising the High Ross Dam. This would involve extensive flooding in the Skagit Valley in British Columbia.

(f) Canada's objections to the Garrison Irrigation Diversion project in North Dakota which it considers a pollution hazard to property and waters in Manitoba.

(g) American concern that projected coal mining on the North Fork of the Flathead River in British Columbia could result in transboundary pollution in Montana.

(h) Differences over whether a projected dam should be proceeded with on the Richelieu River at the outlet of Lake Champlain just north of the international boundary in Quebec.

⁸Since the adoption of the report, both sides have withdrawn the beef quota and GATT has given a ruling favourable to Canada on eggs.

(iv) *Business Concerns*

(a) American concern that Canadian screening of foreign takeovers and of the establishment by foreigners of new businesses or expansion of existing foreign-controlled enterprises in Canada under the Foreign Investment Review Act might prove injurious to American interests.

(b) American objections to the policy of the Canadian Radio and Television Commission encouraging or requiring the deletion of commercials in the cable transmission of programmes originating in U.S. stations across the border.

(c) American objections to the proposed changes in the Income Tax Act which would disallow tax deduction on advertising by Canadians in U.S. television and radio stations and terminate the special exemptions made for Canadian advertisers in Canadian editions of *Time* and *Reader's Digest*.

(d) Canadian objection to the extraterritorial application of certain U.S. legislation as channelled through the parent subsidiary corporative link, for example, the recent difficulties raised concerning Canadian sales of locomotives and furniture to Cuba under the U.S. trading-with-the enemy legislation.

(e) Canadian irritation at the indirect application of U.S. laws and regulations on Canadians by means of private corporate decisions of the parent company. For example, the instructions by American parent companies to their Canadian subsidiaries not to make contributions to political parties, a practice illegal in the United States but legal in Canada.

(v) *Miscellaneous*

(a) The four salt water boundaries between Canada and the United States, one on the east coast, two on the west coast and one in the Arctic, none of which has been settled beyond the three mile limit.

(b) Conflicting claims as to the ownership of Machias Seal Island in the Gulf of Maine.

(c) Canadian objections to land purchases by Americans in several regions of Canada. American objections to land purchases by Canadians in the State of Washington.

(d) American and Canadian differences in fisheries matters off the east and west coasts and on Lake Erie. For example, disputes over the number of salmon taken by each side off the west coast, or differences over the fisheries closing lines off the east and west coasts.

(e) Differences pertaining to the status of the Northwest Passage.

(f) Disagreement over Canadian application of anti-pollution standards in the Arctic and other ice covered waters.

(g) American objections that the Canadian allowances for tourists visiting the United States are not as generous as those allowed to American tourists visiting Canada.

This list of some of the existing problems or irritants between Canada and the United States is by no means a comprehensive one. Moreover, in this present preliminary report on Canadian-American relations, the Committee makes no attempt to comment on or judge the merits of these problems. Many of them will be dealt with in future reports on specific areas of policy.

The list serves, however, to illustrate the importance of the subject to which the present report addresses itself, namely, the mechanisms and channels by which Canada and the United States conduct their relationship. With such a range of complex issues to be dealt with continually by the two countries, it becomes of increasing significance to ensure that the best channel of communications is used, and that the most effective technique for negotiation is employed and that there is careful co-ordination of approaches in different policy areas.

An important factor affecting the ways in which these problems are viewed is the general climate of public opinion in each country regarding the other. As Professor Lyon pointed out, American mass opinion, while still uninformed about Canada, remains basically benign and "presents no problems in the conduct of good congenial relations between the two countries".⁹ The same is not the case on the Canadian side where there has been in recent years, a rising nationalist concern especially over American control of the economy. While the Committee has heard little testimony on this subject as yet, it noted with interest Professor Lyon's doubt that Canadian nationalism is, in fact, as deeply felt as the government seems to have perceived. In the Committee's opinion, the nationalist climate can affect, detrimentally, how Canada approaches some of the current problems between the two countries. The Committee was concerned by Professor Lyon's assessment that

"it would be difficult in the present climate to come up with proposals for new co-operative measures with the Americans."¹⁰

It is the Committee's opinion, that in a nationalist atmosphere, the Canadian government must go out of its way to ensure that difficult problems are handled in as balanced and mature a fashion as possible. There should be a continual awareness by government of the danger of an over-response to nationalist sentiment in its decision-making. Further, it is important that the government be fully conscious of the number and variety of issues in contention between the two countries at any one time. While keeping the totality of these problems in mind, the government should carefully assess the more pressing ones and establish priorities for handling them. Once the priorities have been established, policy choices must be made as well as the strategy and techniques for proceeding. The Committee urges the government to be ever mindful of setting a constructive tone. Style and timing, as several witnesses before the Committee pointed out, are key elements in creating an atmosphere conducive to co-operation and problem solving.

⁹Lyon (9:8)

¹⁰Ibid

Part II: CHANNELS OF COMMUNICATION

“Communications are often difficult, even between friends.”¹¹ With the objective of improving communications between Canada and the United States, the Committee has evaluated various institutions and channels available both at the governmental and legislative levels for communicating and negotiating with the United States.

1. Summit Contacts

Of all the bilateral contacts, it is those at the top, the meetings between Canadian prime ministers and American presidents, which catch the headlines. Over the past half-century there have been 61 such high-level meetings.¹² Their value has been mainly symbolic, public manifestations of the two countries' friendship and common interests. They reassure Canada that it is neither being ignored nor trampled on by its powerful neighbour but being treated in the accepted, dignified and traditional international way.

Summit diplomacy, as Mr. Rufus Smith, a former senior official in the U.S. State Department, has pointed out, is a mechanism to be used at the beginning of a tenure of a new prime minister or a new president to establish, early on, a personal contact which may prove helpful later in an emergency situation. With the ease of communications and the common language and traditions between the two countries, there is a likelihood that in an emergency such a contact would be quickly sought. But as the Hon. Jean-Luc Pepin former Minister of Industry, Trade & Commerce warned, personalities are important in summit encounters. As long as the meeting results in warm and friendly personal relations, a positive tone is set for the staffs on both sides for their guidance in future bilateral contacts. But if personal rapport is lacking, a worsening of relations can permeate down the ranks.

Meetings between the two leaders can be useful in keeping each side abreast of the other's thinking by a “frank exchange of views”, the perennial words of the formal official joint communiqués, on bilateral and multilateral issues. They can also be used effectively to highlight the conclusion of bilateral agreements as when Prime Minister Pearson met President Johnson in Texas in 1965 to sign the auto pact or Prime Minister Trudeau and President Nixon signed the Great Lakes Water Quality

¹¹Davis (8:5)

¹²R. F. Swanson, *Canadian-American Summit Diplomacy 1923-1973*, McClelland and Stewart Limited, Toronto, 1975

Agreement in 1972. The attendant publicity assists the governments in underlining the importance of such agreements.

As several witnesses before the Committee pointed out, “summitry” can be overdone.¹³ With too-frequent use, its symbolic or ceremonial value diminishes and there is a danger it will be viewed only as a cosmetic political exercise. With the inevitable publicity and press-awakened anticipations, commitments are sometimes made or rhetoric indulged in which cannot be carried through. As a case in point, the joint affirmation after the 1969 Nixon-Trudeau meeting which spoke of the beginning of “a new era of consultation between Canada and the United States”¹⁴ was shortly followed by Canada’s unilateral Arctic declaration and President Nixon’s decision to impose his stringent unilateral economic measures in 1971.

The Committee agrees with those witnesses who warned that summit meetings should not be thought of as the mechanism for negotiation of serious bilateral problems demanding complex solutions. A former senior American State Department officer, Mr. Robert Schaetzel, was “fearful of the conversion of international affairs into personal relations” and he warned that,

“This is an essentially dangerous way to approach the highly complicated relations among millions of people and large institutions.”¹⁵

National leaders have little time to become sufficiently well-versed in the details of specific issues for meaningful bargaining to take place and it is difficult for negotiations at the top political level to remain secret, especially in the United States. Further, if the two leaders were to lock themselves into rigid negotiating positions, it would be politically difficult for either to make public concessions. And if there is an impasse at this top level, where else is there to go? Relations could be soured for a lengthy period if a crisis were dramatized in this way at the highest level.

The Committee recognizes that there are occasions when summit meetings can break an impasse encountered at the lower levels. In December 1971 when Canadian negotiators faced an intransigent Secretary of the U.S. Treasury John Connally who did not accept Canada’s arguments for concessions on the surtax or auto pact issues, Prime Minister Trudeau met Mr. Nixon in Washington. No bargaining took place. But in approaching the President directly and explaining Canadian long-term philosophical concerns about the U.S. actions, the log-jam was broken. In Prime Minister Trudeau’s words the main result of this summit contact was a “psychological” one.¹⁶ U.S. officials were subsequently obliged to take their cue from the President and listen to the Canadian viewpoint. The Canadian position was confirmed in the subsequent international monetary settlement. At the next summit

¹³Pepin (11:8) and Schaetzel (2:7)

¹⁴Swanson, op. cit. p. 273

¹⁵Schaetzel (2:7)

¹⁶Press Conference PMO, 7 Dec. 1971

meeting in Ottawa, the President answered the Prime Minister's concern more formally when he addressed the Canadian Parliament in Ottawa in April 1972. A Committee witness, Mr. Rufus Smith, characterized the Nixon assurances in Ottawa as "very very important as policy statements on the part of an American President that had not been said, at least publicly before . . . it helped clear the air quite a bit."¹⁷

Summit Speech-Making

Inevitably when the two leaders make trips to each other's country there are occasions for speech-making. However these opportunities also present pitfalls. In particular there is the danger that the speaker may appear to be telling the other country how to conduct its affairs, as President Kennedy inadvertantly did in the House of Commons in 1961 in referring to Canadian membership in the Organization of American States. This had the direct effect of stiffening Canadian resistance to the idea instead of encouraging it. Similarly, Prime Minister Pearson's 1965 Temple University speech in Philadelphia on U.S. bombing of North Vietnam was badly received by President Johnson.

In connection with Prime Ministerial visits to the United States, the Committee has noted a curious omission. No Canadian Prime Minister has ever addressed the U.S. Congress although it is almost an established custom for an American President to address the Canadian Parliament. Many other heads of government have been given this opportunity in the United States in the past.¹⁸ **In view of the close bilateral relationship and the ease and frequency of top-level encounters between Canada and the United States, the Committee considers that the possibility of a future address to Congress by a Canadian Prime Minister should be explored.**

2. Ministerial Contacts

At the next level—the ministerial level—there are two main channels available:

- a) the one-to-one encounter when a Canadian Cabinet minister deals directly with his Washington counterpart;
- b) the meeting of a Canada-United States joint ministerial committee when several Cabinet officers from both capitals are assembled on subjects relevant to their responsibilities.

The Committee heard testimony from expert witnesses, including several former Cabinet ministers, on the advantages and disadvantages of direct ministerial dealings

¹⁷R. Smith (5:15)

¹⁸The most recent address was by President Sadat of Egypt in October 1975. Some heads of government who have addressed the U.S. Senate and/or House of Representatives are: the United Kingdom, Australia, South Africa, Federal Republic of Germany, Italy, Greece, Japan, Israel, India, Pakistan, Ghana, Nigeria, Ethiopia, etc. Two Governors-General, Lord Tweedsmuir and the Honourable Vincent Massey addressed Congress in 1937 and 1954 respectively.

with Washington at this level. Neither the Joint Ministerial Committee on Trade and Economic Affairs nor the Joint Committee on Defence have met since 1970 and 1964 respectively. The Committee heard arguments as to whether or not this joint institution should be revived.

a) One-to-One Meetings

With easy phone and travel communications for ministers between the two capitals it is inevitable that the one-to-one ministerial level contacts have been increasing and are now an accepted way of doing business. The Committee appreciated a former Cabinet minister's enthusiastic advocacy of the direct approach as a way of cutting through bureaucratic red tape. In his testimony, the Hon. Jack Davis former Minister of the Environment warned that

"big departments, often competing with one another, and layer upon layer of diplomats have made easy relations a thing of the past. The sight of big issues, frequently, is lost in a sea of words. Decision-makers are kept apart. Both sides are agitated by endless static on the one hand and mountains of heavy reading on the other."¹⁹

Ministers, he said, could make the complicated relations with the United States less complicated and could deal directly with issues by working closely with their opposite number in the United States. With his counterpart, Mr. Davis said he had established a regular six-month pattern of meetings which were held with a minimum of fanfare, preferably unannounced, with no press conferences laid on. Scheduled press conferences usually engender anticipation of some major pronouncements whereas his meetings were by their nature often exploratory and the outcome often unsure. The former minister also explained how he often has useful official and unofficial direct talks with his American counterpart at multilateral conferences.

"On these occasions we went over our own list of irritants and talked about policies of common concern for the future. We tried out ideas on each other. We got some feel, quickly, as to their political acceptability. Often we were able to narrow the field immensely. We were able to tell our officials either then or when we got home, what many of the real parameters were. We did not leave them nervously groping for ideas and solutions in the political arena . . ."²⁰

The former minister stated that the Prime Minister had given him "a free hand" to talk to his American opposite numbers and that he had kept External Affairs informed. He had expressed opinions at these meetings and on occasion had given oral commitments.

"The important thing was to communicate.—communicate basically in the area of policy making, with details and protocol taking a back seat most, if not all, of the time."²¹

In contrast to this enthusiastic endorsement of the one-to-one ministerial approach, the Committee heard witnesses who were more sceptical and warned of

¹⁹Davis (8:5)

²⁰Ibid (8:6)

²¹Ibid (8:5)

the dangers and disadvantages of this channel. The Hon. Jean-Luc Pepin considered that Canada should resist tackling problems at higher levels.

“As a rule, that is wrong. Mind you, at times it takes a lot of intelligence and will on the part of political leaders to resist that temptation. How many times in recent years has the press said, ‘The Prime Minister should go down to Washington and settle this or that matter? How many times have they said ‘The Minister of Industry, Trade and Commerce, or the Minister of Finance should go down and solve the problem?’ That temptation should be resisted because problems have a way of clarifying themselves on the way up that invisible ladder.”²²

Mr. Pepin was dubious about the value of establishing personalized relations with Washington counterparts. Although there were some advantages in terms of access and receptivity to arguments, he warned that “the desire to be liked can affect one’s judgment to a certain degree and also there may be some misunderstanding created by the quality of the smile or the warmth of the reception.”²³ He considered that the establishment of mutual respect was more important than close personal relations. It was dangerous, he said, for ministers “to fly down or grab the telephone, unless they have rehearsed their call or speak from notes or take notes.”²⁴

The apparent conflict between the approaches of these two former Ministers can be explained in part by the subject matters with which they were dealing. Some subjects lend themselves more easily than others to frequent use of the direct ministerial channel. Environmental problems, with which Mr. Davis was often concerned, constitute an area where Canadian and American objectives are largely parallel and frequently require a common effort for resolution. Trade and energy issues, on the other hand, where Mr. Pepin was involved, frequently find the two countries in competition. The Committee was impressed by Mr. Davis’ examples of effective use of the direct approach, for example, in persuading the Americans to modify their position on the 200 mile economic zone in respect to fisheries. But in negotiating agricultural trade problems, or auto pact safeguards questions, it would seem wiser to try to work out solutions first at lower levels before resorting to the ministerial dialogue.

While recognizing that there has been a great multiplicity of contacts at the ministerial level between Washington and Ottawa, the Committee regards their effectiveness as dependent on certain prerequisites. Much hinges on the personalities involved. A good personal liaison can only be established if the individuals on both sides welcome it. Some contacts will be useless or counter-productive when personalities clash and could better be left to official channels. Canadian ministers have, on occasion, found some U.S. Secretaries rigid. Certain meetings between opposites have been marked by friction and confrontation. Most contacts between ministerial

²²Pepin (11:7)

²³Ibid (11:8)

²⁴Ibid

counterparts, however, have been viewed by both sides as constructive and useful channels of communication.

Not only do personalities need to harmonize but, as Mr. Robert Bryce former Clerk of the Privy Council and Deputy Minister of Finance, related

“the important thing is that one realizes that it is a very serious business . . . and ministers have to be properly briefed, not only about the subject but about the man they are meeting.”²⁵

A risk involved in meetings between ministerial counterparts is that commitments could be made which have not been thoroughly assessed beforehand. In such a case, difficulties of interpretation and implementation might ensue. Another danger of one-to-one ministerial contact is the possibility that issues handled in a private meeting between two Cabinet-level officers may be dealt with in too narrow a context, losing sight of broader national perspectives. A minister tends naturally to concentrate on and be well versed in his own subject. This could lead to the unintentional distortion of a complex issue. Mr. Schaetzel pointed out the United States Cabinet system does not lend itself to as co-ordinated an approach as the Canadian system since American Secretaries are generally less conscious of a collegial responsibility.

In summary, the Committee considers that one-to-one ‘ad hoc’ ministerial contacts are important and useful mechanisms in the Canadian-American dialogue. They are not an easy panacea for difficult conflicts and they should not be used without thorough preparation. But there are undoubtedly occasions when an impasse occurring at a lower level can be broken or when a better understanding can be sought by the direct ministerial approach.

b) A Co-ordinated Cabinet Approach

Friction in Canadian-American relations has been caused on occasion by Canadian domestic policies which have had an unanticipated impact on the United States or when policies affecting a United States interest have not been assessed in terms of the broader implications for Canadian-American relations. With interdependence between the two countries intensifying, this problem is likely to become more serious in the future.

The Committee heard testimony pointing out that ministerial-level Cabinet Committees have increasingly replaced interdepartmental official-level committees in the policy reconciliation process.²⁶ This places an added burden on busy ministers. To guard against the risk that Cabinet or its Committees might take decisions having an unintentional spill-over effect on the United States or that the broad ramifications of a policy affecting a United States interest have not been assessed in

²⁵Bryce, (2:37)

²⁶Ibid (2:33)

terms of its effect on the overall relationship, the Committee recommends that Cabinet put in place some mechanism to ensure full policy coordination. For example, there may be instances where a Canadian objective could be achieved by either of two policies, but that one of the two would be less disturbing to the Americans. These kinds of options should be carefully examined.

In this connection, the Committee understands that there is already an obligation that all policy memoranda submitted for Cabinet consideration contain an assessment of the effect, if any, of the policy proposals on federal-provincial relations. In view of the importance of the Canada-United States relationship, a relationship which is in most respects of more importance to Canada than all its other external relationships combined, **the Committee recommends that some similar mechanism be worked out to ensure that all Cabinet memoranda are assessed in the light of the effect, if any, of the proposals made in them on Canadian relations with the United States.**

c) Joint Ministerial Committees

During the early stages of the hearings, many members of the Committee were inclined to favour a revival of the Canada-United States Joint Ministerial Committee on Trade and Economic Affairs as a way to counteract the risk of "tunnel vision" or overspecialization by individual ministers. This Joint Committee which has met 13 times since it was formed in 1953 provided a forum for ministers on both sides concerned with trade, economic, financial and agricultural problems. As originally designed, the Joint Ministerial Committee was an informal mechanism for the exchange of views and for dealing with issues *before* they required decisions. It was intended neither for bargaining nor for joint decision-making. It provided a setting in which priorities could be established and the required degree of urgency assessed. Opposite numbers came to know each other—a fact which facilitated later telephone calls or personal encounters where necessary. New ministers found it particularly informative and useful. Perhaps most important, the meeting provided a broad approach, an antidote to the concentrated viewpoint of individual ministers who were obliged to take account of their colleagues' different perspectives. Mr. Schaetzel called it a "cross fertilization" of ideas between ministers.²⁷

Unfortunately the early informality of the meetings gradually came to be replaced by a more structured approach. More and more time was spent on preparation of the joint communiqués which were in themselves reactions to the press demand for decisions. The encounter became increasingly a platform for predictable, set speeches from each side. Formal position papers were drawn up and exchanged. Each minister was accompanied by a battery of civil servants. The informal frank discussions of the original meetings were lost. At a time when the bilateral issues were becoming enormously more complex and more specialized, the

²⁷Schaetzel (2:12)

meetings began to appear more futile with the discussions adding little to mutual understanding.

Another drawback has been that too much publicity has nullified the original exploratory and consultative purpose of this channel. Quick decisions and easy solutions were never intended to result from these meetings. One has only to imagine the national publicity and anticipation which would be aroused at the present time if a number of Cabinet officers concerned with energy matters, including financing, pipeline construction and environmental issues were to meet in such a format. National expectations would make such an exercise politically counter-productive for the Canadian ministers concerned.

The Committee views these developments with regret. The joint ministerial meetings, as Mr. Robert Schaetzel pointed out, not only broadened the perspective of both sides but, even more importantly for Canada, they

“force[d] the American Government to think, at least once a year, about Canada on an orderly basis and within a set context. In fact, the in-house briefings in preparation for the meetings, with Cabinet officers brought together just for this purpose, might well be the most important asset of this process.”²⁸

The Committee considered the obligatory focus by senior American Cabinet officers to have been an invaluable feature of this institution. However, the task of bringing the eight or ten U.S. Secretaries and Canadian Cabinet Ministers together for two or three days once a year has become an almost impossible one in the 1970's. In recent years, the pace especially for the American side has intensified as busy Cabinet members are expected to participate in the ever-increasing number of international meetings around the globe. While the Canadian Government naturally concentrates a major portion of its time on its policy toward the United States, the American Administration is more preoccupied with responsibilities in other parts of the world. It can devote only a small percentage of its attention to Canadian affairs.

The Committee would like to see a revival of the original pattern of informal discussions which characterized the early meetings of the Joint Ministerial Committee. Unless this could be done, which seems doubtful, **the Committee has concluded with regret that this joint institution, in the structured form it has recently taken, serves no constructive purpose and may even be counter-productive in the conduct of relations between the two countries.** This does not mean, however, that the joint ministerial committee mechanism should be abolished. It still exists on paper and would, therefore, be available if it were decided by both sides to revive it in its original form or to call it for any special purpose.

The Committee considers that some of the advantages which resulted from the earlier more informal, ministerial meetings could be achieved by joint meetings at the under-secretary or deputy-secretary level, a recommendation which is advanced on page 26.

²⁸Schaetzel (2:6,7)

3. Official-level Contacts

It is at the official level that the majority of Canada's dealings with Washington are handled—and their range is enormous. The principal Canadian institutional mechanisms for such bilateral contact are the Department of External Affairs, the Canadian Embassy in Washington and the Canadian consulates scattered across the United States. In addition, most departments of the federal government also have direct working contacts with their opposite numbers in the United States government. Officers from nine departments are assigned to the Embassy in Washington.²⁹ Contact, negotiations and discussions between the officials of the two countries also frequently take place at multilateral conferences or at meetings of a vast number of international bodies of which both countries are members, including the United Nations, NATO, GATT, IMF, etc.

a) Contacts through External Affairs

Within the Department of External Affairs, the predominant position of the United States in Canada's domestic and foreign affairs and in world affairs requires that a great deal of departmental time and effort is devoted to Canada-United States relations either directly or indirectly. In addition to the sections which are particularly concerned such as the Bureau of Western Hemisphere Affairs, the Bureau of Economic and Scientific Affairs and the Bureau of Defence and Arms Control Affairs, scarcely any division of the department is uninvolved in the relationship in one way or another.

The Canadian Embassy in Washington is the focal point of the conduct of Canadian relations with the United States. Among the main functions of the embassy staff is the cultivation and maintenance of contact with American officials in various fields and the detailed reporting back to Ottawa on the situation in the United States with special attention to those developments of interest to Canada. The overall function of the embassy is to communicate and explain Canadian views to the United States authorities and interpret the American viewpoint to Ottawa. As Mr. Armstrong, a former senior official in the U.S. State Department put it,

“One of the basic functions of diplomacy . . . is to make sure . . . that if there is a clear U.S. position on the subject, the Canadian government knows what it is, whether it likes it or not; and vice versa, to see to it that one's own government has a clear picture of what the other government's position is.”³⁰

In describing the embassy's activities for the Committee, the former Canadian Ambassador in Washington, Mr. Marcel Cadieux, commented that in the new

²⁹In addition to the Department of External Affairs, members of the following government departments are serving at the Embassy in Washington: the Department of Industry, Trade and Commerce (including the Canadian Government Office of Tourism), the Department of Energy, Mines and Resources, the Department of Agriculture, the Department of Defence, the Department of Labour, the Department of Supply and Services, the Department of National Revenue, and the Royal Canadian Mounted Police.

³⁰Armstrong (2:24)

circumstances of “the third option”, the challenge to maintain a harmonious relationship with the United States is now greater than before. He outlined the broadening activities of the embassy which include 17 different programmes ranging

“from political, economic and defence relations, information and trade, industrial development to travel, marketing, police liaison, energy, supply and services, labour, provincial interests, the environment, and transport and communications.”³¹

Particularly important aspects of the embassy’s work are its contact with the U.S. Congress, its information work in the United States and its handling of the interests of the provinces. These topics are discussed below separately. With high speed communications, the practice has grown of sending experts from Canada to undertake negotiations. The embassy now conducts negotiations with the United States government less frequently than formerly. However, preparation for these negotiations and support for the Ottawa-based delegations has become, according to the Ambassador, one of the major tasks of the embassy.

Canada maintains consulates-general in New York, Boston, New Orleans, Los Angeles, San Francisco, Seattle, Chicago and Atlanta, and Consulates in Philadelphia, Buffalo, Dallas, Minneapolis, Detroit, Cleveland and San Juan, Puerto Rico. Their prime responsibilities are in the fields of trade promotion, information work, tourism and immigration. The consulates also try to keep informed and involved in contacts between provincial and state representatives. The Committee noted from the Ambassador’s testimony however that further expansion of the consulates’ role into the area of political reporting would have to await the provision of a confidential communications system between Ottawa and Washington and the fifteen consular posts. The Committee sees this as a legitimate goal which would allow increased political reporting as well as effective information work to be done at the consulates. The consulates located across the United States are both useful listening posts and valuable resources which are not being fully utilized.

These traditional diplomatic channels, the Department of External Affairs, the embassy and the consulates, have certain obvious advantages over direct contact between functional officials in other departments in Washington and Ottawa. Because of their formalized structure these mechanisms continue to function during periods of strained relations. It is generally agreed that they are, by length of experience, the most knowledgeable instruments for making bilateral contact and the most aware of the concerns and policies of the other country. They have a parallel and receptive counterpart in the U.S. State Department and its embassy and consulates in Canada. It was brought out in the hearings that there has always been a greater knowledge of and sympathy for Canada in the State Department than in other parts of the American bureaucracy. Mr. Armstrong considered there was a greater risk of bilateral difficulties when the State Department channel was bypassed by direct dealings between functional departments. It was also suggested

³¹Cadieux (4:5,6)

that during the past several years there had been a movement in Washington to restore responsibility for relations with Canada to these normal institutionalized channels rather than relying so frequently on the network of established and informal personal contacts which could sometimes be friendly but might also be strained, as was the case five years ago in the financial field. These appear to be some valid reasons for using the established diplomatic links in official dealings.

b) Direct Contact Between Functional Departments

There is however a multitude of regular day-to-day contacts between officials in the functional departments in the two capitals dealing directly with each other in their subject areas. Such direct contacts are natural and inevitable in view of the range, complexity and technicality of issues between the two countries. Ottawa must be prepared to use the best expertise available and cannot hope to funnel all contacts with the United States through one departmental channel. Nor could one government department hope to provide the necessary expertise in all areas.

The numbers involved in such direct contacts are startlingly high. In 1968 a count was made of the number of Canadian federal ministers, heads of agencies and officials which went to the United States. Twenty-three government departments and ten agencies were involved. The figures for that year were: 3,034 visits to Washington, 9,866 visits to other points in the United States making a total of 12,900 such visits.³²

c) Contacts at International Conferences

It is difficult to measure the extent of contact between Canadian and American officials at international meetings and multilateral conferences. However, the Committee noted that the Canadian Ambassador to the multilateral trade negotiations under the GATT, Mr. Rodney Grey, stressed in his testimony to the Committee the importance of these bilateral contacts. He described repeated instances of how, during the preparatory period and during negotiations, he was in contact with his American counterparts.

"It would be quite foolish not to make it a regular part of the delegation's business to maintain contact with the United States delegation at every level, and all the more so because of the nature of the process. They arrive at Geneva at the technical level extraordinarily well prepared. . . . Because of the importance of our trade with the United States and the fact that they have developed their position on every issue, perhaps more than any other country has, because they do this at the legislative stage, it is vitally important that we talk to them."³³

This situation is multiplied at countless numbers of international meetings in a variety of fields. Because of geography and because of similar institutions in the two

³²Minutes of Proceedings and Evidence, House of Commons Standing Committee on External Affairs and National Defence, No. 3, 20 November 1969, Appendix "A", page 3:64.

³³Grey (17:9)

countries, Canadian and American positions at such conferences are frequently in concert or complementary. It is usually useful for Canadian officials to be aware of the American viewpoints and, where the objectives are similar, to prepare and develop positions with this in mind in order to achieve the desired objectives.

d) A New Joint Official-Level Institution

One suggestion raised during the Committee hearings by a former U.S. Minister in Ottawa, Mr. Rufus Smith was for the formation of a Canada-U.S. committee of officials at the deputy minister/assistant secretary level. In discussing ministerial-level contacts the Committee has concluded that periodic meetings of groups of Canadian and American ministers had ceased to be productive as presently structured. But the original need served by these joint ministerial meetings remains and, in fact, is probably greater than ever.

In 1973, the then Under Secretary of State for External Affairs, Mr. E. A. Ritchie, accompanied by the deputy ministers of Finance, and of Industry, Trade and Commerce visited Washington for two days of informal discussions about issues in Canadian-American relations. The participants apparently felt it was a highly successful meeting. The objective of similar future meetings, as Mr. Rufus Smith pointed out, would be "simply to keep each other alert to the plans and trends in the other country."³⁴ Without a formal structure, without any planning mechanisms without powers of decision, the group—the composition of which should be small and flexible—could meet whenever either side considered it useful. Unlike the situation in the meetings of ministers, press interest and public expectations would be negligible, since it would be understood that the group would have no decision-making powers—both because this is a power which accrues to ministers and also because the meeting would refrain from anything resembling negotiations. The Committee recognizes that deputy-ministers, like ministers, are busy men, but nevertheless believes that the scheduling of such a meeting would be much easier than setting up the joint meetings at the ministerial level. The Committee puts forward this proposal convinced that steps must be taken on both sides to overcome the "tunnel vision" which on occasion prevails and to achieve the concentrated but broad focus on the relationship which is now lacking.

The Committee concludes that the government should explore the idea of 'ad hoc' joint meetings between Canadian deputy ministers and American deputy secretaries. These meetings should be unstructured, informal and called on an 'ad hoc' basis whenever either side considered it would be useful to get together to discuss bilateral issues. The composition of the meeting would include those deputy ministers and deputy secretaries concerned with the items under discussion. In the interests of policy co-ordination on the Canadian side however, the under-secretary of state for External Affairs should always be present.

³⁴R. Smith (5:7)

e) The Co-ordination Role of External Affairs

The functional departments in Ottawa and Washington, as mentioned earlier, have frequent direct contact at the official level. In fact many functional departments in Ottawa have international sections of their own, set up to deal with issues having international dimensions in their specialized field such as environment, fisheries, agriculture, etc.

However direct dealing between functional departments in the two capitals raises major problems for government organization. How can a single bureau or department keep track of all the bilateral dealings when they are dispersed among so many departments? How can the government ensure that departments are not working at cross purposes in respect of Canadian policy toward the United States? As Mr. Bryce, a witness with long experience in a functional department, explained:

"In the case of Canada and the United States, one of the special difficulties is that there is an excellent telephone service between the two. One is tempted to deal with so much by telephone that does not produce a written record and it is often troublesome to send out notes of what you have said on the telephone so that even within departments it is difficult to make sure the senior officers of the departments are fully aware of what various assistants have been doing."³⁵

In addition, officials, telex messages and mail fly back and forth across the border between the two capitals with great frequency and rapidity.

The Committee agrees with several of its expert witnesses that there is no alternative to using the traditional channel at the official level, namely the Department of External Affairs, as the central policy co-ordinating mechanism. It is by far the best equipped to do the job, and for reasons cited previously, there are particular advantages. The Committee recognizes however that this puts a heavy burden on External Affairs. It must keep other interested and involved departments fully informed of all incoming information including the distribution of telegraphic messages from its posts. But to do the co-ordination job effectively it must also be knowledgeable in all relevant areas such as energy, environment, science, technology, etc. and fit these special considerations as far as possible, into the overall pattern of Canadian policy to the United States as decided by the government. External Affairs is such a large and complex department that it may even be difficult to get a reconciled viewpoint from competing functional divisions within it.

The Committee found that there does not appear to be any fixed pattern or method by which functional officials from other departments keep External Affairs informed, it being left to the judgment of senior officers in these functional departments. As Mr. Bryce put it,

"The determination of these matters which should be taken up with External Affairs is a difficult question of judgment which is only learned in my opinion by a study of particular cases and the achievement of some feel for the situations . . . Which incidents must be taken up with External Affairs depend on the judgment as to how important they are in affecting our general relations with the United States or how far they might affect government

³⁵Bryce (2:35)

policies, which may be prejudiced one way or another by the manner in which matters are settled within a particular field."³⁶

This question of keeping External Affairs informed of direct bilateral dealings is closely related to the broader problem of policy co-ordination and the reconciliation of conflicting departmental viewpoints. While reconciliation of important policy differences is now effected at the Cabinet Committee level rather than by inter-departmental committees of officials, there still remains a substantial number of decisions made by various government departments in the course of their normal duties which will affect Canada's relations with the United States. Naturally viewpoints will differ between departments. The same "tunnel vision" or over-specialized perspective which can affect ministers' judgments can apply even more readily to individual departmental officials immersed in their special subject. The possibilities for confusion and conflict in respect to policy with the United States are enormous. **But internal co-ordination is essential if Canada is not to present a confused and discordant policy voice to the United States.**

The Interdepartmental Committee on External Affairs (ICER) was set up in 1970. Among other responsibilities, it involves those departments most actively engaged in Canada's foreign operations in the establishment of priorities and the allocation of resources in the programmes in various countries or areas. ICER has no formal role in the co-ordination of Canadian policy toward the United States. Its functioning, however, has resulted in a better awareness between departments of each others' interests and concerns in various areas, and has promoted 'ad hoc' interdepartmental co-ordination techniques. In particular the "country programme system" whereby representatives from different departments come together for weeks at a time to sort out priorities and pare down requests from the missions abroad has contributed to this process.

The usual steps toward achieving co-ordination and reconciliation of viewpoints between departments involve, to begin with, the widespread informal network of contacts between officials. Subsequently if an issue is not easily resolved it might be discussed at an 'ad hoc' interdepartmental meeting. Depending on the subject it could then be dealt with by a special standing interdepartmental committee such as the one for the GATT negotiations comprising senior deputy ministers and chaired by the under-secretary of state for External Affairs. A disputed issue will go higher and higher on the official ladder. If a matter cannot be reconciled or if a policy issue is involved it will reach the Cabinet Committee level where ministers, with officials present as advisers, will argue it out. But it is not an easy process, and Mr. Bryce stated that on occasion he had even found it easier to get a co-ordinated governmental decision through the embassy in Washington than from Ottawa departments since the embassy was a much smaller organization. As it included representatives

³⁶Ibid (2:36)

from various departments, the consultation process was that much easier. He warned,

“There is no way you can avoid doing a lot of hard work if you are going to co-ordinate.”³⁷

In the Committee’s view this is one of the most difficult problems it examined in its study of the existing machinery. It agrees with Mr. Bryce that much hard work is involved. The Committee notes with approval that External Affairs itself is concerned with the problem and has recently established its own task force to enquire into External Affairs’ role in interdepartmental co-ordination as it affects foreign affairs.

The problems of co-ordinating Canadian foreign policy vis-à-vis the United States present External Affairs with a particularly difficult task since so many intrinsically domestic policies now have some degree of impact on the United States. **The Committee stresses the need for effective policy co-ordination whether at the official or the Cabinet level. In the Committee’s opinion there is a responsibility on the part of both the functional department and External Affairs.** Officials of the functional departments have a responsibility to alert External Affairs concerning any dispute or decision which may have an impact on the United States. They should keep a record of their direct dealings with American departments and use their judgment carefully and responsibly as to whether the matter under discussion warrants bringing it to the attention of External Affairs. For its part External Affairs should be aware in detail of the actual or potential interests of the functional departments and keep them informed of all ongoing developments relevant to these interests.

4. Provincial Contacts and Involvement

The constitutional responsibilities of the provinces encompass areas which touch on industrial strategy, resource policy, commercial policy, education and cultural fields, public finance, agricultural policy, labour relations, corporation laws and manpower concerns. As Mr. Ian Macdonald, a former Ontario deputy-minister in charge of intergovernmental affairs, put it, these are all matters of provincial concern but all have a deep imprint on Canada’s foreign policy requirements. He continued.

“It is not difficult to see why the provinces have more than a yearning but indeed a responsibility to make an effective contribution to that process”³⁸.

The problem for the federal government, which alone is empowered constitutionally to conduct relations with a foreign country, is how to take account of the views of the provinces to try to integrate them into its policies toward the United

³⁷Bryce (2:40)

³⁸I. Macdonald, (3:8)

States. How also can it solve the problems of being unable, under the constitution, to legally bind the provinces into certain bilateral agreements which it may wish to conclude. Finally, it must try to provide adequate and effective institutional channels through which the provinces can make contact with the United States. There is a danger, if these problems are not resolved satisfactorily that the provinces will increasingly take matters into their own hands. A plurality of Canadian voices will be heard in Washington with a consequent weakening of Canada's influence and an undesirable effect on national unity.

The provinces are involved, directly or indirectly, in Canadian-American relations at three main levels:

- a) directly, through province-state contacts;
- b) via the federal governmental machinery, with Washington; and
- c) within the framework of an international conference where Canadian-American issues are being worked out.

Both b) and c) involve some form of federal-provincial co-ordination or consultation.

a) Direct Province-State Contacts

Paralleling to some degree the intergovernmental channels of communication at the federal level, the province-state contacts fall into the following general categories:

- i) mini-summit meetings between provincial premiers and state governors, usually between neighbouring provinces and states along the border. These meetings sometimes take the form of a regional meeting such as the Conference of New England Governors and Maritime Premiers;
- ii) official-level contact at the province-state level. This usually involves informal administrative contacts between officials of various functional departments concerned with mutual problems such as highway construction, fire-fighting measures or international bridge maintenance;
- iii) inter-legislative conferences between members of provincial and state legislatures such as those organized on a regional basis on the east coast.

There are also a number of provincial trade and investment offices in various American cities: the Alberta Government office in Los Angeles, the Nova Scotia Information Office in New York, the Government of Ontario offices in New York, Chicago, Los Angeles, Cleveland, Atlanta, Boston, Minneapolis, the Government of Quebec offices in New York, Boston, Chicago, Dallas, Lafayette and Los Angeles.

The Committee heard witnesses from several provinces and states on the subject of province-state dealings. It was interested to learn the extent and nature of these contacts. Testimony revealed not only frequent encounters at the premier-governor level but in several cases the development of close personal relationships. However, it was evident that by far the largest number of contacts have taken place at the

official level. The Committee was surprised to learn that there were 766 agreements, understandings or arrangements in effect between Canadian provinces and American states by 1974.³⁹ These arrangements for the most part have been developed by officials on both sides who were intent on working out 'ad hoc' common sense arrangements to solve day-to-day problems of neighbouring communities and regions. By their number and variety, however, they reflect an important element in Canada-United States intergovernmental relations. Basically administrative in nature, they are not generally regarded as binding under international law. The accompanying table gives a breakdown of the categories covered by this type of contact.⁴⁰

Functional Categories	Agreement	Understanding	Arrangement	Totals by Functional Categories
Agriculture			27	27
Commerce & Industry	2	5	73	80
Educational & Cultural		10	34	44
Energy	1	12	23	36
Environmental Protection	1		64	65
Human Services		12	64	76
Military & Civil Defence	4	3	9	16
Natural Resources		24	125	149
Public Safety			36	36
Transportation	35	112	64	211
Unclassified	1	3	22	26
Totals by Types of Interaction	44	181	541	766

³⁹Roger F. Swanson, "State-Province Interaction" A study of relations between U.S. States and Canadian Provinces, prepared for the U.S. Department of State, Bureau of Intelligence and Research, Washington, D.C. August 1974, p. 41.

⁴⁰Ibid, page 41 Dr. Swanson defines an 'agreement' "as a jointly signed document setting forth regularized interactive procedures; an 'understanding' as correspondence, resolutions, communiqués, or memoranda, not jointly signed, setting forth regularized interactive procedures; and where there is no reported jointly signed document or correspondence, resolutions, communiqués or memoranda, the contact is described as an 'arrangement'. Of the total number of this type of contact over 70.6% are in the form of arrangements, 5.7% are agreements and 23.6% are understandings.

It is evident that the majority of these province-state contacts have been useful to both sides of the border and have generally had a positive effect on the overall conduct of Canada-United States relations. For instance the conference of Great Lakes premiers and governors in 1970 has been credited with providing an added impetus to the conclusion of the Great Lakes Water Quality Agreement between the two countries in 1972. The co-operation between Ontario and states bordering on the Great Lakes in regard to this agreement provided a sound basis for the development of the Transboundary Air Quality Control Understanding Affecting Ontario and Michigan. The Premier of New Brunswick, Mr. Hatfield, emphasized to the Committee the friendly and positive attitude which ensued from the discussions and exchanges of information at meetings between New Brunswick and Maine. These proved especially valuable when Canadian oil exports to Maine were cut off in 1973. As Premier Hatfield told the Committee:

"Feelings between the two countries were badly strained and the feelings between Maine and New Brunswick were substantially strengthened because we both understood, having had these discussions, how difficult the problem was."⁴¹

Because of the interdependence of the economies of two border communities and their common front to the two federal governments, the oil supply to this area of Maine was restored.

The Committee is aware however that while good informal working relationships have evolved along the border in many areas, there are stresses and strains in some regions because of particular conditions. As Dr. G. Rutan, an academic witness from the State of Washington pointed out, this is particularly the case in the somewhat geographically closed-in area comprising the lower mainland of British Columbia, the southern tip of Vancouver Island and the most heavily populated area of the north-west of the State of Washington. Currently in this area there are a number of serious cross-border irritants including coastal tanker traffic, Canadian land purchases in the State of Washington, the supply and price of natural gas exports, the transborder television advertising dispute, and the Skagit River and Point Roberts controversies. In a situation where population pressures are beginning to be felt, Dr. Rutan said, it has become harder to adopt a friendly attitude and minor irritants tend to be exacerbated. Dr. Rutan also pointed out that an outspoken political style can have a negative effect on the overall tone of the relationship.

The Committee concludes that in dealing with local problems, a significant number of useful and successful working relationships have been established along the border. The province/state link can deal with these administrative border problems more effectively than any other body. The Committee agrees with Mr. Ian Macdonald who stated

"... The development of those contacts, both formal and informal, helps greatly to relieve the atmosphere of tension which from time to time marks our border relationship with the United States."⁴²

⁴¹Hatfield (7:8)

⁴²I. Macdonald (3:7)

Many of the problems in some areas such as the west coast, however are substantial and will have to be handled at the federal level. The Committee is of the opinion that if, at the province/state level, both sides could demonstrate good will and understanding in trying to clear away as many of the minor irritants as possible this would help to promote a positive attitude in which major problems can be settled.

In this respect, the Committee was impressed by the comment of Dr. Young, of the University of Victoria who pointed out that there was no office or single official in Victoria charged with the responsibility of overseeing British Columbia's relations with Washington State. Dr. Young stated:

"One of the things that the Province of British Columbia should do is to assign some official in the premier's office or some other official in the government apparatus the task of simply monitoring and maintaining some idea of precisely what is going on . . ."⁴³

The Committee trusts that great care will be exercised by provincial authorities in assessing whether the problem they are dealing with is likely to become an international rather than a local issue, in which case the federal government should always be involved.

Several specific ideas have emerged from the testimony of provincial experts and the Committee commends them to the provinces' attention in respect to their contacts with neighbouring states:

- **Where there are extensive relations with a neighbouring state as well as a number of difficult problem areas, the province should give consideration to assigning to a provincial government official the responsibility of overseeing the relationship and "of monitoring and maintaining some idea of what is going on".**

In order to improve co-ordination of Canadian policies toward the United States, the Committee suggests the following:

- **When a province contacts an American state on a matter other than of a local administrative nature or reaches agreements with an American state, the federal government should be kept informed. When such agreements are reached at regional conferences, they could be brought jointly to the attention of the two federal governments in order to illustrate regional interests and interrelationships more fully.**
- **The provinces should keep the Department of External Affairs or the embassy in Washington informed of any official visits to the United States of provincial ministers or of their senior officials. For instance, when provincial premiers make official visits to the governors of a neighbouring state, the nearest Canadian consul should be kept fully informed and if possible should be represented at the meeting. Similarly a representative of the embassy in**

⁴³Young (13:16) Since the adoption of the report, the newly-elected Premier of British Columbia has appointed an official in the premier's office to fulfil this function.

Washington or from External Affairs in Ottawa or from a consulate should be present at regional conferences between premiers and governors and between legislators.

The federal officials may often, through their wider contacts, provide useful assistance. Moreover, their presence will ensure that Ottawa is kept informed of the development of province-state relationships and that the impact of these regional developments on relations between the two countries is better understood.

b) Provincial Contacts with Washington

The established channel for provincial contacts with Washington is the Federal-Provincial Co-ordination Division of the Department of External Affairs. This section was set up in 1967 in response to the growing involvement of the provinces in Canadian-American relations. Its tasks were defined by External Affairs:

- “It attempts to keep in regular and close contact with provincial officials so as to remain aware of provincial aims and policies relating to international questions of interest to them . . .
- It places the Department’s network of posts abroad and its extensive telecommunications facilities at the disposal of provincial officials.
- It arranges and coordinates the constantly increasing number of visits of provincial officials abroad and of foreign officials to the provinces.
- It facilitates contacts between the provinces and foreign governments . . .
- It seeks to ensure that provincial representatives are represented on Canadian delegations to international conferences dealing with matters of interest to the provinces. . . .
- It continues to develop procedures that will make it possible to distribute to the provinces on a regular basis miscellaneous information and documentation relating . . . to provincial areas of interest. The most recent specific example . . . is the ‘information flow’ system which has been set up from our Embassy in Washington in order to provide the provinces, in a systematic manner, with information of direct interest to them.”⁴⁴

The function of the Federal-Provincial Coordination Division is an important one but not an easy one to fulfil. Difficulties can arise when provincial ministers and civil servants go to the United States without notifying the Department of External Affairs or the Canadian consul in the state visited, or in not notifying them until the last moment of an impending visit. If the embassy is to fulfill its function of arranging productive visits to Washington by provincial figures, it needs adequate advance warning of the visit and its objectives. Further, as Mr. Cadieux pointed out, provincial co-operation in this regard is important if Canada is to avoid giving the

⁴⁴From material supplied to the Committee July 23, 1975

impression in the United States that there are conflicts between different levels of government.

A specific programme under the Co-ordination Division relates to the embassy's programme of provincial interests and the recently established "information flow system". This arrangement is designed to meet some of the expressed needs of the provinces in respect to Canadian-American relations. A senior federal civil servant at the Canadian Embassy in Washington has been designated as "provincial interests officer". This officer is assigned the task of dealing with provincial representatives' visits to the United States, of trying to ensure that the embassy is the channel of communication or is fully involved in discussions between the provinces and the U.S. federal or state governments and of supervising the reporting on certain subjects to provincial governments. He also keeps in touch with the consulates which are instructed to alert the embassy when they receive requests from a province. Under the "information flow system" material which is thought to be helpful to an interested province is selected by the provincial interests officer in Washington and channelled to them via External Affairs. Under the arrangement made with Ontario, it was agreed that this material would relate to U.S. policies and developments concerning energy, the auto pact, trade policy and the Great Lakes. In addition, the embassy does some economic and political reporting to a few interested provinces on particular subjects and is prepared to brief provincial officers on special subjects when in Washington or in the provincial capitals.

The "information flow system" is the result of negotiations between Ontario and the federal government after the August 1971 Nixon economic measures. Ontario complained of a lack of information from Ottawa on issues of provincial concern and proposed the opening of its own provincial office in Washington. Alberta made a similar suggestion at that time. Negotiations ensued between Ottawa and Ontario and the idea was explored of having an Ontario government representative at the Canadian Embassy. When this idea presented too many problems it was agreed that the embassy itself would undertake to provide the information service to the province.

Mr. Ian Macdonald explained to the Committee why Ontario had considered some new machinery was urgently required. At the time of President Nixon's import surcharge, he said,

"Ontario was not receiving from the federal government the information which it felt it needed to comment intelligently on U.S. proposals having important implications for the economic and social policies of the province . . . When each of those policies emanating from Washington has an indelible imprint on labour policy, on location of industry, on the export pattern and on the daily lives of everyone in the province, no provincial premier can afford to be uninformed, or indeed, can afford not to be intimately involved in any of these areas . . ."⁴⁵

The witness explained that the information flow would reduce "the reactive nature of Canadian policies vis-à-vis the United States" and result in provincial governments

⁴⁵I. Macdonald (3:7)

“being well informed so they are not taking public positions which tend to exacerbate tense relationships between Ottawa and Washington.”⁴⁶ The information flow was designed

“to serve as an advance warning device on developments that bear on provincial concern. The provincial ministers want to have some intimation of what is coming rather than to hear later what has taken place.”⁴⁷

It is evident that the procedure is still in the development stage. Although Mr. Cadieux stated it would be gradually extended to other provinces, only one other province, Alberta, is participating in this new facility at the present time. Further, testimony revealed some practical problems in the programme mainly stemming from the fact that the federally appointed staff members of the embassy responsible for provincial interests in Washington are not yet fully acquainted with the needs of the provinces. According to Mr. Macdonald this has led to some difficulties in the selection and transmittal of material. It is clear that the provinces will need to specify the type of information they would find useful.

On the whole, however, the Committee considers that the appointment of the provincial interests staff in the Canadian Embassy in Washington is a positive step forward in coping with the problem of provincial involvement in Canada's relations with the United States governments and in helping to decrease the pressure on certain provinces to have their own offices in the United States. The Committee hopes that other provinces with important relations with the United States will assess the procedure and, if it is judged useful, will participate in this programme.

In the interests of improving the functioning of this new mechanism, the Committee makes the following recommendations which arose from evidence heard:

- **Canadian Embassy officials responsible for provincial interests and the “information flow system” in Washington should spend some time in capitals of interested provinces in order to become better acquainted with the provinces’ perspectives and needs vis-à-vis Washington.**
- **Because of the fact that economic questions are now the paramount concern of most provinces, more emphasis should be put on commercial and economic work and less on the traditional broader diplomatic reporting by Washington.**
- **In order that federal foreign service officers become more proficient in understanding provincial problems and perspectives in the foreign affairs field, some officers should be commissioned to spend a period of time in provincial capitals working where available in the intergovernmental affairs office. They would then return to Ottawa to work in the federal-provincial co-ordinating unit of External Affairs. A federal programme called **Interchange Canada** is already in place under which such an exchange could be worked out.**
- **In order that provincial officials can gain a better understanding of the federal services available from Washington, they should be able to spend a week or two**

⁴⁶Ibid (3:8)

⁴⁷Ibid (3:9)

at the Canadian embassy in Washington. Opportunities might also be provided by the Washington embassy for provincial cabinet members and senior provincial public servants to go to Washington for briefing or discussion sessions “to be exposed to the decision-makers in Washington.”⁴⁸

- **When a province has a particular interest in a certain developing situation, a representative from that province should be assigned to the staff of the embassy in Washington on a temporary basis “as is the case with delegations to international conferences.”**⁴⁹

c) Provincial Input into the Formulation of Canadian Policies to the United States

Dissatisfaction has been frequently expressed by the provinces that they do not have adequate procedures for expressing their viewpoint when the federal government is formulating its policy vis-à-vis the United States. Even when they have been consulted, the provinces have been critical that their opinion is not sufficiently taken into account.

Nowhere is the federal-provincial consultative process more important than in the formulation of Canadian policy toward the United States. As pointed out earlier the constitutional responsibilities of the provinces overlap the federal government's jurisdiction in a wide range of areas including resources, investment, labour relations and trade. These matters while primarily domestic are, at the same time, inextricably linked to federal policies vis-à-vis the United States.

There are a variety of existing channels for the expression of provincial views: the annual premiers' conferences; the federal-provincial meetings of counterpart ministers; the provincial government submissions to the Senate and House of Commons Committees during the legislative process (for example the Foreign Investment Review Act and the Competition Act); the official-level consultations which are co-ordinated by the Privy Council and/or the Department of External Affairs and the informal “ad hoc” consultations between functional departments in Ottawa and their counterparts in the provinces. Additional devices by which the federal government has solicited provincial views in the formulation of foreign trade policy are the Canadian Trade and Tariffs Committee (CTTC) and the federal-provincial Deputy-Ministers' Committee on the Multilateral Trade Negotiations (MTN) which were set up to receive briefs and representations. As Mr. Grey explained to the Committee, there are a number of federal trade policy positions involved in the present GATT negotiations which could have a direct impact on provincial policies vis-à-vis the United States and other countries. The provinces quite naturally wish to have an input in the formulation of this Canadian position.

According to the testimony of the Hon. Jack Davis, federal-provincial consultation procedures concerning technical and environmental problems such as Great

⁴⁸Ibid (3:17)

⁴⁹Cadieux (4:12)

Lakes quality seem to be working quite well. Mr. Davis explained to the Committee how he tried to overcome the federal-provincial 'gap' by federal-provincial ministerial meetings and by the ongoing Council of Resources and Environment Ministers, chaired in rotation by the provinces. He stated,

"Policy was made in this way and misunderstandings of the type that occur all too frequently between the federal government and the provinces were cleared up or avoided altogether."⁵⁰.

In respect to the GATT negotiations, considerable effort has been made by the federal government to solicit provincial input. Through the two mechanisms mentioned above, the CTTC and the Deputy Ministers Committee on the MTN, and through direct contact, there have been numerous opportunities for the provinces to put forth their views, and to be briefed on the latest development at the GATT Conference. Provincial deputy ministers have met the CTTC; the Minister of Industry, Trade and Commerce has met with provincial ministers; federal officials have visited the provincial capitals to consult on aspects of commercial policy particularly with respect to the export of natural resources; and working papers and viewpoints have been exchanged. Finally, federal officials from the Tokyo Round negotiations return from time to time and try to report first-hand to provincial officials. Mr. Grey stated he thought there would have to be federal-provincial contact throughout the negotiations from the ministerial level down to the highly technical level. In this regard, the Committee noted Mr. Grey's comment that the provincial administrators will be facing a very heavy burden of work in "defining what their interests are and expressing those interests, as these very complex negotiations proceed."⁵¹ They are faced with the need to coordinate the interests of their own functional departments in order to present a coordinated provincial or regional viewpoint to Ottawa.

Despite these and other positive steps in federal-provincial consultation in the formulation of foreign policy it is clear that there are still gaps in some areas, most specifically concerning energy policies and in regard to certain commercial policies. The recent British Columbia government's policy regarding gas exports and the Ontario government's policy regarding tax rebates on North American cars are cases in point. Given the current complexities of bilateral and multilateral problems there is still considerable room for improvement and refinement of procedures. Several provincial witnesses spoke of the need for more openness and less reluctance on the part of the federal government in divulging information. This would improve the provincial and federal governments' ability to act in concert. Mr. Ian Macdonald pointed out the enormous implications for Ontario of federal trade policy to the United States since 81 percent of Ontario's exports are to the United States. Ontario needed to be consulted and to have some intimation as to what was coming rather than hear later the explanation for what had taken place. He continued,

⁵⁰Davis (8:8)

⁵¹Grey (17:13, 15)

“The process I think is simply too secret and too slow, and in this day and age the means employed too often do not justify the results. I think the successive lack of openness is an impediment to the fuller integration of the various viewpoints across the country.”⁵²

and later

“The only way one is going to get a good national policy composed of federal and provincial inputs, is for an effective partnership process to exist from the beginning of these problems. There must be openness, candour and co-operation all down the line.”⁵³

He also emphasized the importance of early attention to common problem areas so that the federal and provincial governments could work on it together “with a far enough horizon to be effective at the time the so-called crisis occurs.”⁵⁴ This did not happen in the energy field before 1973.

Another method of involving the provinces in policy formulation is to have provincial representatives present either as observers or participants in consultations when Canada and the United States negotiate on bilateral issues of special concern to a particular province. For example in 1974 British Columbia was represented at bilateral discussions on west coast tankers and Manitoba was on the Canadian delegation which went to Washington to discuss the Garrison Diversion scheme. However, such a solution might be inapplicable at a Canada-United States conference on energy in which every province would consider its interests were involved in one way or another. It would be difficult to decide which province or provinces should be represented and how the representatives who are chosen could speak for Canada rather than merely for their individual province. In such a case a national Canadian position must be worked out with the provinces beforehand.

In conclusion, the Committee considers that the federal government has prime responsibility in the development of mechanisms to involve and, if possible, integrate provincial viewpoints in Canadian policies toward the United States. While there has been substantial progress in this regard in recent years—to the point that Canada has become a federal state worthy of world attention—further refinement of the consultation and co-ordination processes is needed. There needs to be, as Mr. Macdonald has pointed out, a new awareness at the federal level that a national foreign policy properly includes both federal and provincial activities, not merely federal matters. There needs to be more openness by federal departments and agencies regarding the overall direction of Canadian policy toward the United States and a greater degree of solicitation by Ottawa of provincial views. **On the provincial side there is a responsibility to organize a central contact point or channel of communication with which the federal authority can deal on foreign affairs matters.** There has been frustration on the part of the federal government and officials in not knowing with whom they should deal in some provincial governments. In this connection the Committee makes the following suggestion:

- **The provinces should endeavour where possible to equip themselves with a counterpart agency parallel to the External Activities Branch in the Intergovern-**

⁵²I. Macdonald (3:8)

⁵³Ibid (3:23)

⁵⁴Ibid

mental Affairs Division of the Department of Treasury, Economics and Intergovernmental Affairs of Ontario, in order to provide a focussed channel of communication with the federal government in the foreign affairs field.

5. Special Joint Mechanisms

From time to time persons concerned about Canadian-American relations have proposed that the pattern of successful resolutions of water boundary problems between the two countries by the International Joint Commission (IJC) should be applied to other bilateral problem areas—either by extension of the IJC's authority itself into other fields or by using the IJC as a model for the establishment of similar joint bodies. These proposals have led the Committee to examine the IJC not only from the point of view of assessing its own effective functioning, but also as a possible model mechanism for problem-solving in areas such as energy, trade, balance of payments, auto pact or even in the problems of defining the four salt water boundaries between Canada and the United States.

a) The International Joint Commission

Of all the existing permanent joint institutions linking the two countries, the IJC is the oldest, is the most independent, has the broadest mandate and the most notable record of achievement.⁵⁵ Created by the Boundary Waters Act of 1909,⁵⁶ the IJC consists of six members, three appointed from Canada and three from the United States. Its two national sections work together as one unit under the two national chairmen. It has four main areas of responsibility:

- (i) a semi-judicial function of approving applications to alter the level of flows of boundary waters and of rivers that cross the boundary.
- ii) the function of investigating and making recommendations to the two governments on specific boundary problems referred to it by either or both governments. In practice this has meant references which are formally agreed to by both governments.
- iii) an arbitral function which has never been used.
- iv) a continuous monitoring and surveillance of water levels, air quality, water quality and remedial programmes arising out of either specific applications, references or agreements, notably the Great Lakes Water Quality Agreement of 1972.

By far the largest number of cases now come before the Commission under references, under item (ii) above, the terms of which are usually carefully negotiated by the Canadian and American governments.

⁵⁵See testimony of Hon. Mitchell Sharp (1:34-39) Session 1974 for a list and description of other joint bodies to which should be added the Canada-U.S. Trade Statistics Committee.

⁵⁶For various reasons, the actual establishment of the Commission was delayed until 1912.

Since its own staff in both countries is of very modest proportions, the IJC is normally authorized, upon taking up a referred problem, to call upon the best qualified technical experts and officials from the departments and agencies of the two federal governments or state/provincial governments or from outside of government. It organizes these experts into an international investigative board composed equally of Canadians and Americans acting as a unit under joint chairmen. After completing its investigations, which usually include public hearings, the board reports as one to the Commission. The Commission itself may make public the Board's report and hold further hearings before issuing its own report to the governments. Neither government is bound by the reports or recommendations of the Commission's investigations.

The Great Lakes Water Quality Agreement of 1972 added considerably to the responsibilities of the Commission. This agreement asked the IJC to monitor and keep under surveillance the programmes undertaken by the two countries which were aimed at achieving agreed water quality objectives in the Great Lakes. In this case the Commission was given specific authority to publicize its views and recommendations which enabled it to criticize either government for not living up to programme commitments. It is also free to recommend any changes in the agreement designed to protect the environment. In this sense it acts as an environmental ombudsman along the Great Lakes.

While the Commission has been criticized, perhaps unfairly, from time to time for its slowness in reporting or for the high cost of investigations which resulted in reports which found no easy answers,⁵⁷ the successes of the IJC over its more than 60 years history are indisputable. In 98 cases there have been only four instances where the Commissioners have divided or failed to reach an agreement.

From Canada's point of view, one of the most important features of this permanent joint machinery has been the parity of membership which has made equals of two very disparate nations. The Canadian IJC Chairman, Dr. Cohen, elaborated:

"... Here was an asymmetrical relationship between a small Canada, still almost semi-colonial, and a great power, which together in 1909 were able to devise a system to create symmetry in the relationship of the two countries . . . through the theory of equality on the Commission and equality on the boards in the field . . . Size did not matter."⁵⁸

A second most important element of this mechanism is the built-in predisposition to constructive problem-solving which has developed over the years. As Dr. Cohen explained, there has grown up a pool of hundreds of Canadian and American civil servants who have worked together on IJC cases. When they "wear the IJC hat" during investigations, they feel an obligation to the Commission.

⁵⁷The Great Lakes Water Levels Report was a case in point. Strongly criticized in the U.S. Congress, it had taken 9 years and a considerable cost to reach a conclusion which found that effective remedial action would be uneconomic.

⁵⁸Cohen (6:6)

“Even though they do not forget their nationality or their own departments, something happens when they sit ‘collegially’ as against the position if they were sitting ‘adversarily’ on behalf of their governments”⁵⁹.

An American Commissioner, Charles Ross, has called it an “esprit de corps” and commented that “to the greatest possible extent, national sovereignty gets lost in the shuffle.”⁶⁰

Fundamental to the success of the IJC is the common fact-finding process which de-politicizes each problem and unites both technical staffs in the search for the basics of the situation.

The Committee recognizes that the problems along the boundary which the IJC is being asked and will in the future be asked to solve are becoming increasingly complex. Dr. Cohen pointed out that

“the boundary is no longer simply a boundary made up of boundary waters and trans-boundary waters. But now with air pollution and land uses that affect water pollution and air pollution, you have what I call an environmental/developmental complex—an interaction of air, land and water all along the common frontier.”⁶¹

In the face of more complex interrelated issues, satisfactory solutions may be harder for the Commission to achieve. Present environmental concerns which could not have been foreseen by the treaty-makers of 1909, may force certain modifications in the IJC procedures. The governments might find useful a somewhat broadened authority for the IJC.

The Committee urges the Canadian government to examine the following recommendations with a view to their implementation jointly with the United States:

a) The Committee recommends that the IJC should be given the authority on its own initiative to make preliminary examinations or assessments of potential pollution problems along the boundary, to point out potential sources of trouble and dispute and to suggest to the two governments that a reference should be made. This would, in effect, constitute a watching brief on environmental problems all along the border. At present the Commission must await a reference from the governments before making an inquiry or investigation into such problems. As an example, the Committee is of the opinion that the current Garrison Diversion problem might have been headed off had the Commission had this watchdog capacity. As it is, this irritant was allowed to develop much too far before a reference was made to the IJC. The end result of the dispute will undoubtedly involve the governments in remedial actions and expense which could well have been avoided had the IJC had the competence to anticipate the problem.

The Committee hopes that such an extension of authority could be granted without opening up the Treaty. It understands that the two governments have

⁵⁹Ibid (6:7)

⁶⁰Address to the American Society of International Law, Washington, April 1974.

⁶¹Cohen (6:13)

already given the Commission a similar watching brief in regard to air pollution all along the border. The same technique could presumably be used in regard to an extension into other pollution problems. If not, perhaps a standing reference could be given.

b) The Committee recommends that the IJC should have extended power to publicize all its recommendations. While the Commission now has power to publicize its views under the Great Lakes Water Quality Agreement, such authority is not automatically given in respect to other areas of its competence under the Boundary Waters Act. Commission recommendations can only be effective when they are adopted and carried out by the governments and agencies concerned. In the past there have been important instances where no government action was forthcoming. The most notorious case was surely the continued inaction of the two governments in the face of repeated IJC recommendations concerning pollution in the Great Lakes. Beginning in 1918, the IJC warned that the condition of the lakes was “generally chaotic, everywhere perilous and in some cases disgraceful.”⁶² Fifty-four years later, when Lake Erie was all but dead, the Great Lakes Water Quality Agreement was signed. **The IJC should be able to publicize the shortcomings of governments in all areas and to ask for explanations, after a suitable period has elapsed, as to why no action has been taken.** The Committee believes that the good judgment of the IJC Commissioners could be relied upon to ensure that the power to publicize would be used responsibly.

The Committee has taken note of Dr. Cohen’s point that the IJC must strive to retain the confidence of the departments which supply its technical staffs and the governments which support it. Nevertheless the Committee believes that in fulfilling its Great Lakes pollution tasks, the Commission has gained credibility in publishing its forthright criticism of governments not living up to their clean-up programme commitment. If used responsibly, a similar extension of authority to criticize publicly deficiencies in other areas would be a rational outcome of the IJC work which would be widely accepted. Through the years the IJC has built up a considerable weight of its own. The public would not only accept but expect the Commission to follow up its recommendations in this way.

In view of these possible extensions of authority, the Committee hopes that the two governments will take care always to appoint a high calibre of Commissioners, that extended vacancies on the Commission will not be allowed to occur, and that a too-rapid turnover of Commissioners will not take place, making it difficult for any expertise to develop.

Finally the Committee recognizes that such extensions of the IJC powers to act as a pollution watchdog and to publicize its reports’ recommendations would inevitably entail an increase in the Commission’s very small staff and budget.

⁶²A.D.P. Heeney “Along the Common Frontier”: *Behind the Headlines* C.I.I.A. 1967, p. 11.

However such an increase would be limited since the Commission's watchdog capacity resulting from the terms of certain specific applications and references already exists in a number of boundary areas across the country.

b) The IJC's Powers Extended to Other Areas

Various proposals have been made to extend the IJC's competency into other areas. In the 60's both the Merchant-Heeney Report and the report of a group of Republican Congressmen suggested that the Commission could be used to resolve other problems between the two nations. Professors Dworsky and Francis have outlined to the Committee their proposals for enlarging the Commission's task in the Great Lakes basin into an overall management and planning role bringing together in a co-ordinated way the efforts of the many agencies and organizations already responsible for different aspects. Other proposals which have been raised concerning extension of IJC powers have included the possibility of the IJC defining, through arbitration, the Canada-U.S. salt water boundaries; the authority to deal with pollution problems in salt water along the coasts; the granting of powers of enforcement to the IJC; the right to undertake new references on its own initiatives; or the possibility of a unilateral reference being given by one government to the Commission.

The Committee does not think that such extensions of the Commission's functions would necessarily be in the best interests of the Commission or of bilateral relations. It considers that priority should be given to extending the IJC'S responsibilities in the two ways recommended earlier in this report. If the IJC were to be given too much new responsibility, such as an arbitration power, in addition to its present semi-judicial, investigative and administrative functions, this could destroy its effectiveness in these important areas. Moreover, it could cause it to be bypassed by the United States. U.S. Commissioner Charles Ross has warned,

"The danger has been and always will continue to be that even with equal representation, the country with the most clout will have a tendency to neglect such a joint institution because it has other ways of influencing the decision of any international problem or dispute. Canada has always, and understandably so, relied upon the IJC more than the United States."⁶³

The Committee endorses the view expressed by Mr. Rufus Smith that the two governments should not overburden this useful mechanism and expect it to carry more of a load than it is designed to bear.

c) The IJC as a Model for Other Binational Commissions

Another proposal which has frequently been put forth is that Canada and the United States should set up other joint commissions modelled on the IJC in order to resolve bilateral differences in different fields. In other words, that permanent joint machinery should take the place of 'ad hoc' negotiations or consultations on

⁶³Ross, op. cit.

particular subjects. Specifically a joint transportation commission, and a joint economic commission have been proposed as well as commissions in other fields such as trade, energy, balance of payments and investment.

After deliberation the Committee remains sceptical about these proposals. The IJC has certain special attributes which could not be easily reproduced in other settings. The IJC, the two other joint bilateral commissions concerned with fisheries⁶⁴ and the International Boundary Commission concerned with demarcation of the boundary line, all involve a common decision-making process arising from the equal responsibilities and common goals both countries share in regulation of specific and limited border subject matters. In the case of boundary waters and boundary markers matters, each side has an equal interest in establishing the factual data and in resolving difficulties. In the case of the joint fisheries commissions, the common objective is preservation and development of shared fisheries. Depleted fisheries require scientifically-based remedies and regulations.

It is true a joint committee exists in the defence field. In this case the sensitivity of the subject has caused the joint machinery to function in a quite different way from the IJC. The Permanent Joint Board of Defence (PJBD) was set up in 1940 with a structure paralleling that of the IJC and probably modelled on it. But it has developed quite different working practices. The PJBD does not work collegially, nor does it report jointly, differences which are natural enough when one considers the disparate defence structures and the unequal responsibilities of the two sides. Nonetheless the PJBD has served as a useful consultative and advisory body, helping to mesh complex military requirements with political, economic and other concerns of the two governments.

However, such conditions as are found in these areas are not paralleled in economic, financial or energy fields where there is rarely an identity of interest between the two countries. More frequently the interests are in some degree of conflict. Indeed, they usually involve important areas of national policy in which no government would wish to relinquish freedom of action. In the Committee's opinion, it is unrealistic to suppose that the United States would be willing to grant parity of membership and to sit jointly under a common commission 'umbrella' in order to reach a consensus in such sensitive areas. Such a process would be equally unacceptable in Canada.

While it is true that the governments have, in the past, created joint committees in some of these fields, such as the Joint Ministerial Committee on Trade and Economic Affairs or the Canada-U.S. Balance of Payments Committee of the 1960s, these committees have been channels of communication, consultation and co-ordination rather than of common investigation and even decision-making characteristic of the IJC. There has been no question of such committees sitting "collegially" to reach a consensus, nor does it seem possible that in their deliberations "national sovereign-

⁶⁴The International Pacific Halibut Commission and the Pacific Salmon Commission.

ty [would be] lost in the shuffle.” Furthermore as we have seen, even these committees have fallen into disuse because direct ‘ad hoc’ contact was found to be more suitable in present conditions.

While the Committee doubts that commissions on the IJC model can be set up in economic areas, it considers that certain elements of the IJC’s work can provide a useful example for problem-solving in some fields. The aspect of the IJC model which is most easily applicable to some bilateral disputes involves the fact-finding procedures used by the IJC investigative boards. An illustration of a problem which the common fact-finding technique helped to solve is the bilateral trade statistics dispute of 1971.⁶⁵ There is no reason why this process could not be applied more often to resolving disputes of a technical nature where it is important to lay bare the factual data. In the field of energy, for example, are there not established facts regarding transportation costs, pipeline routes, or pipeline building techniques which are being needlessly duplicated on both sides of the border at great expense and which could be established by a single joint committee to the benefit of both sides?

Another proposal for a joint body which has come to the Committee’s attention is in the field of agriculture, an area where American and Canadian interests have frequently been in conflict. World food scarcities may be changing this situation. A leading world food expert⁶⁶ has recently suggested that since the rest of the world is likely to look increasingly to North America for its food supplies, especially grain, Canada and the United States have a new responsibility. To cope with this world dependence, he suggested that Canada and the United States should form a joint body to formulate and adopt a responsible North American food policy using it to support a positive world food strategy. It is a difficult but challenging idea which the government might explore.

6. Legislative Channels

(a) The Embassy and Congress

Constitutionally, a distinctive feature of the U.S. system of government is the independent powers with which the Congress is vested. Recently this significant attribute has attained new importance. According to the testimony of Dr. David Abshire, a former associate undersecretary for congressional affairs in the Department of State, there has been in the past few years a “virtually unparalleled” shift of power from the Executive to the Congress. This shift, explained by Dr. Abshire, is closely related to the extraordinary economic powers exercised by Congress, as opposed to the politico-military powers of the President. The Executive has no way around the Congress on economic questions, which are exercised “particularly [by]

⁶⁵This subject is discussed more fully below on page 60.

⁶⁶Lester R. Brown, *Financial Post*, October 11, 1975: “*Why North America must take the world food lead*”

the House Ways and Means Committee and . . . the Finance Committee”.⁶⁷ Given the intense interdependence between Canada and the United States in the trade and economic field, there are significant implications for Canada in the new strength in Congress.

Dr. Abshire pointed out yet another important change—a new diffusion of power within Congress whereby the traditional Congressional leadership hierarchy has been challenged, and even deposed in some instances, and extensive new power assumed by the Democratic caucus. This decentralization of Congressional power and the loss in influence of the traditional Congressional leadership means that individual Congressional opinions now count for much more. Dr. Abshire commented:

“To put it bluntly, many foreign officers of many governments and many missions in Washington have been very slow to perceive the implications of this shift in power in this foreign affairs field to the committees dealing with economics.”⁶⁸

Has Canada been slow to perceive it? Is the Canadian government’s liaison work with Congress active enough? The Canadian Embassy’s activities in this field were described by the Ambassador:

“This is an important, expanding but delicate aspect of our work. There is, at minimum, a public relations and an information job to be done . . . We now have an officer who is assigned to this work on a full time basis. He develops links with the executive assistants and research specialists of the legislators, he keeps score of legislative contacts maintained by Embassy officers and constantly reminds them of this important aspect of their operations in their respective fields. The chief responsibility for expanding parliamentary and congressional liaison must rest, however, on all officers at all levels.”⁶⁹

Undoubtedly there is a certain limitation as to how far an Ambassador can go in ‘lobbying’ Congress. As he is formally accredited to the Administration, he should not actively and visibly lobby on Capitol Hill against a clear-cut policy of the Administration, particularly if he appears to relate to or negotiate with prominent Congressional opponents of the White House. However, when an American witness, Mr. Rufus Smith, was asked by the Committee how far the Canadian Ambassador could go in lobbying Congressmen, he replied,

“He can go pretty far . . . As a practical matter in my opinion, the Canadian Embassy staff has a pretty free hand in cultivating people on the Hill and making sure the Canadian point of view is understood.”⁷⁰

For a variety of reasons Canada has been far more reticent and less active in this field than some other large countries which have less at stake in economic terms. In deciding on a cautious approach, the Canadian government may have been unduly influenced by its own parliamentary system and therefore may not have taken sufficient account of the critical fact that the division of powers in the United States produces an entirely different situation. Or perhaps there is a conviction that the

⁶⁷Abshire (15:17)

⁶⁸Ibid.

⁶⁹Cadieux (4:9)

⁷⁰R. Smith (5:9)

U.S. Administration is in a better position than the embassy to counter Congressional action which might be detrimental to Canadian interests and therefore that it was wiser to work through the State Department. This presupposes that the State Department is always prepared to put forward Canada's position and is able to do so effectively.

In the Committee's opinion this is not the case at the present. As a result of Vietnam and Watergate, the U.S. Administration and particularly the State Department has much less influence than formerly as an interpreter of international developments as far as Congress is concerned. As a recent example, in the Turkish arms embargo vote in Congress it was the personal persuasion of anxious European and NATO figures which convinced some key Congressmen to shift their vote and may have saved Turkey from leaving NATO. Similarly Canada cannot expect that the Administration will always be able to convince Congress of the validity of Canadian arguments on a particular issue. **Canada should ensure that its case is put directly to Congress as well as to the Administration.**

Dr. Abshire pointed out that

"the great problem we face in our Congress with respect to Canadian relations is the lack of awareness of the dimensions involved."⁷¹

Like the majority of Americans, most Congressional figures tend to take Canada for granted and have little realization of the extent and depth of the economic ties. How can Canada overcome this unawareness? Dr. Abshire stated that there were "many modes, many methods of having an important dialogue with members of Congress"⁷² without coming between the Executive and Congress.

In contacts with Congress, Dr. Abshire stressed the importance of selectivity in view of the large numbers of senators and representatives in Congress. He cited the efforts of the Embassy of Japan, a country which has a smaller amount of trade with the United States than has Canada.

"Over a period, the Japanese . . . had about all the members of the Ways and Means Committee one way or another to the embassy and in a very helpful manner that created mutual understanding."⁷³

Indeed, the primary focus for the embassy's activities should be the members of the key Committees, such as Ways and Means, or Finance which are constantly dealing with matters vital to Canada's trade, energy or environmental concerns. Dr. Abshire also suggested that as the first years in Congress are likely to be the formative ones, newly elected members should be sought out. He could have added that newly elected members are much more accessible. The burden for these efforts, which mainly involve the development of personal contacts, will inevitably fall on the Ambassador and senior officials concerned with trade and energy matters.⁷⁴

⁷¹Abshire (15:18)

⁷²Ibid (15:19)

⁷³Ibid (15:18)

⁷⁴See also the discussion below on page 72, regarding the government's information programme and Congress.

The Committee recognizes that the task is a difficult and frustrating one for the embassy. Results will be hard to measure and slow in coming. There are many competing claims on the time of embassy staff. Novel techniques, foreign to the way of the diplomat, have to be developed to catch the interest of Congressmen. It may be necessary to have officers specializing in the field assigned to the embassy for extended postings, since so much depends on personal connections which cannot be routinely passed from one officer to his successor. The aim must be to develop the capacity to acquaint, in the time of need, some critical Congressmen with the Canadian viewpoint when our interests are involved. Canada must not depend on the State Department and other agencies of the Administration to act on its behalf.

The Committee urges the government to recognize that it is of crucial importance to Canada's relationship with the United States that the embassy take a more positive approach to Congress. Contact with Congress has been neglected too long. In the face of Congress' new expressions of power and its vigorously independent attitude in foreign and trade policy matters, it is essential to Canada's economic interest that the official Canadian viewpoint be heard by influential Congressional figures as well as by the Administration. Almost inadvertently, Congressional unawareness or misunderstanding of Canada's position could cause severe economic or trade dislocations in this country. **The Committee considers that Congress should become an area of concentration for the Canadian efforts and that the government should provide the embassy as soon as possible with the instructions and the means for an expanded Congressional relations programme.**

(b) Parliament and Congress

The other important Canadian link with Congress is through its legislative counterpart, the Canadian Parliament. In addition to the encounters between Canadian and American legislators at inter-parliamentary meetings such as the NATO Assembly or the Inter-Parliamentary Union or the Parliamentary Assembly of the Council of Europe, there is a bilateral inter-parliamentary connection, the Canada-United States Inter-Parliamentary Group. Established in 1959 by joint legislative action, this institution was designed to bring delegations of both legislatures together regularly to discuss mutual problems. The Group could become an important instrument for increasing Congressional awareness of Canada. Politicians on both sides of the border relate particularly easily to each other and quickly appreciate each others' problems. Unfortunately for a variety of reasons the Group has not come close to achieving its potential to date.⁷⁵ In 1973, criticism and dissatisfaction over the lacklustre annual meeting were expressed by members of the returning Canadian delegation. They pressed for improvements. Based on a careful analysis of past deficiencies, two main proposals for reform were initiated. First, the Canadian side re-organized its internal affairs, with the aim of appointing capable,

⁷⁵See M. J. Abrams: *The Canada-U.S. Interparliamentary Group* for further description of this institution and its functioning.

persuasive and well-informed Canadian delegations. Second, suggestions were put to the American side for joint decision relating to the format, timing, locale and agenda for the meetings designed to improve the quality and value of the discussions between delegations. The American side agreed and the Committee noted a marked improvement in the 1975 meeting in Quebec City for which the joint chairmen on both sides are to be congratulated.

The Committee urges that this effort to improve the functioning of a potentially important legislative link with Congress be further developed. There is no other inter-parliamentary link nearly as important to Canada. Canadian delegates should be of top quality, well prepared and selected because of their knowledge and experience concerning items on the agenda. While Canada has no input into the selection of members of the American delegation, this Committee shares Dr. Abshire's opinion that United States delegates to Group meetings should be drawn not only, as traditionally, from the foreign affairs committee but also from committees dealing with finance, trade and energy matters, that a "broader base of members of our Congress be involved".⁷⁶ It is to be hoped that other influential Americans embrace Dr. Abshire's view.

On two occasions in recent years, Canada has sought a special one-day meeting of this Group (as compared to the normal three or four-day meeting) to explain the Canadian position on controversial subjects. The first involved discussions of the potentially heavy impact of the August 1971 U.S. surcharge and the second resulted from Canadian alarm at the prospect of west coast oil spills following Congressional approval of the Alaska pipeline. These two meetings, focussed on specific issues, were useful in bringing new reciprocal understanding of differing viewpoints and concerns. The Committee considers that this technique constitutes a valuable additional mechanism for bilateral dialogue. Care should be taken however that this device is used only in exceptional cases where the issues involved are of national importance and recognized as such.

The Committee concludes that there is no other inter-parliamentary contact more important to Canada than that with the American Congress. The Committee therefore strongly urges the selection of delegates to the annual Canada-U.S. Inter-parliamentary Group meetings who are carefully chosen as to individual areas of expertise and adequately briefed in order to put Canada's case as effectively as possible to American legislators.

7. The Impact of Resolutions of Parliament

Quite apart from its legislative role, the Parliament of Canada can act in ways which may have an impact on Canadian relations with the United States.

From time to time—and particularly during periods of minority government—Parliament may pass resolutions critical of the actions of other governments. In

⁷⁶Abshire (15:20)

recent years a number of these have been aimed at American activities or policies, notably a 1971 resolution condemning the Amchitka atomic underground test, a resolution in 1972 criticizing the Cherry Point oil spill and two in 1973, one objecting to the proposed flooding of the Skagit River Valley and the other deploring the U.S. bombing of North Vietnam. These resolutions were expressions of strongly held Canadian views. All were passed by unanimous consent—that is without debate or even a formal vote, with the government, for a variety of reasons, associated with the passage of each resolution.

The government's reasons for doing so have varied. Sometimes, as on the Amchitka underground tests, the government felt a resolution of Parliament would add weight to the protests which it had already lodged in formal diplomatic notes. During the minority government, its control of the House was weaker and the government was afraid of being shown up domestically. So, when public furore boiled up over American bombing of Hanoi and Haiphong and the New Democratic Party (NDP) came forward with a strong resolution condemning U.S. actions, the government concluded it did not wish to take the risk of blocking it and decided to preempt by having the Secretary of State for External Affairs submit a milder text. Sometimes—and the resolution on the Skagit River Valley is a good example—a resolution can be pushed through the House by a combination of skilful tactics and thorough preparation. In this instance the key factor was the choice of a day for submitting the resolution. A member of the Opposition put forward his resolution when the key minister—the Secretary of State for External Affairs—who would have objected and so blocked passage of the resolution was out of the country.

The impact of such resolutions on the United States varies enormously. The resolution on bombing in Vietnam, for example, offended the United States Administration mainly because it had been introduced by the Secretary of State for External Affairs. While the Canadian government's decision was understandable in domestic political terms, no account appears to have been taken of how the action would be interpreted in the United States. Few Americans understand how the Canadian system of government works and instinctively they equate the situation to that prevailing in the United States where Congress and the President have separate powers, and where the norm is for the executive to oppose Congressional resolutions critical of other countries. In the American view, the appropriate action for Mr. Sharp should have been to speak out against the strong NDP resolution and let the chips fall where they might.

Because both countries have similar economic and social systems and democratic forms of government, it is often assumed in the United States that the political systems of the two countries are similar. With the best intentions in the world, Americans think and speak of Canada as “a close neighbour”, “a next-door cousin”, a “sister nation”, presuming a very close similarity of institutions, a parallel working of government. In reality, of course, the Canadian political system is quite different from the American; apparently similar institutions may operate differently. The

socially-felt kinship belies dissimilar political systems—not “sister states” but distinctive “nation states”.

To remedy such misunderstandings it is important that the Canadian public information programme in the United States pay special attention to explaining the workings of the Canadian political process. The Committee recognizes, however, that this is a long-term project. In the meantime, while the Committee has no criticism of Parliament for exercising its constitutional prerogatives, it is important that the government, as distinct from Parliament, consider carefully the effect of its action in such circumstances.

Part III: TECHNIQUES FOR CONDUCTING RELATIONS

1. Advance Consultations

At a succession of top-level meetings in recent decades the leaders of the two nations have constantly renewed a pledge to avoid unnecessary acrimony and open disputes by early advance consultation on policies which will have an appreciable impact on the other country. Nevertheless, there have been notable lapses on both sides. It is evidently a formula which needs constant reiteration and fresh commitment. At a time when there are bound to be new areas of friction in the energy, investment, agricultural, even environmental fields, and when the domestic economic and social measures of one country are tending increasingly to impinge on the life of the other, there may be a new necessity for a commitment to advance consultation as an essential practice in order to preserve harmonious relations.

Basically a commitment to advance consultation means the undertaking by one government to communicate intended changes of policy which could adversely affect or embarrass the other. (This "ad hoc" consultation process is distinguishable from the ongoing consultative process which takes place almost continuously through mechanisms at the lower level). The objective of "ad hoc" advance consultations is, at the least, to seek understanding through explanation as to why a specific policy change is necessary. At best, it can achieve a reconciliation of divergent viewpoints; at worst, it protects a government from the embarrassment of being caught unawares. The commitment to consultation must be seen to be reciprocal for it to work. It must take place before a policy is announced publicly.

In a recent speech, the Secretary of State for External Affairs affirmed his understanding of this process.

"It seems to me a sensible way of doing business is to notify the United States whenever possible of our intentions in advance of our taking major decisions on matters affecting United States interests and where appropriate to provide an opportunity for advance consultations."⁷⁷

It sounds like an easy recipe to ensure harmonious relations. Yet the Committee recognizes that advance consultations with Washington are not always easy for the Canadian government when the policies involved arouse strong controversy within Canada quite apart from their impact on the United States. The federal-provincial relationship renders decision-making a delicate process in some areas and can delay and greatly complicate any consultations with Washington. Further, not all crises are predictable and there may be occasions when speed and secrecy are essential.

⁷⁷MacEachen, Winnipeg, C.I.I.A., 23 Jan. 1975.

Mr. MacEachen implicitly acknowledged to the Committee yet another problem in ensuring consultations—that of the unawareness of other departments of the importance of such consultations,

“I cannot guarantee there will not be slip-ups. I am telling you my point of view in terms of established policy in the department and the policy which must frequently be reasserted in Cabinet . . .”⁷⁸

The Committee questions whether it is sufficient simply to reassert the policy of advance consultation in Cabinet, a step presumably taken only after some failure to do so has occurred. The Committee has already suggested that all Cabinet memoranda should require comment on whether the proposed action might affect Canadian relations with the United States. If this practice were to be adopted, it would be easy to add the requirement that in any instance where relations would be affected, the comment should include a description of the proposed arrangements for advance consultation.

The Government's recent handling of the export of natural gas provides a more constructive illustration of this technique at work than its earlier handling of beef imports or the oil export tax about which the former American Ambassador Mr. William Porter complained, “we have been confronted by decisions in food and energy without opportunity for effective consultation.”⁷⁹ In the case of natural gas exports, Canada in 1975 gave the United States advance warning of the National Energy Board findings on natural gas so that Washington was not caught by surprise. The government and the Minister of Energy, Mines and Resources made it clear to the United States that Canada has no intention of making American consumers who were dependent on Canadian gas bear the brunt of the Canadian shortfalls. The burden would be shared, Ottawa said, and it undertook to work closely with United States energy officials before any reductions were made. The Department of State publicly welcomed the Canadian assurance of further consultations. This constituted a constructive approach to problem-solving between the two countries, one which minimized possible acrimony and recognized that Canada had a continuing obligation to take account of and to consult over the impact of Canadian decisions in this field on the United States. Less constructive was the brusque treatment accorded the United States Pacific Northwest in 1974 by the British Columbia government in curtailing gas exports on the premise that American buyers should absorb practically all of an unexpected local shortage.

Each case requiring consultations is likely to be unique and no fixed pattern can be adhered to. The preferable form of consultation should take place as soon as the government has decided on its objectives, its methods and time-table for achieving its objectives. It should then seek to explain the policy to the United States, listen to its reaction and, if appropriate, make any necessary adjustments. Such a procedure for

⁷⁸MacEachen, (16:10)

⁷⁹Porter, Winnipeg, C.I.I.A., 25 September, 1974

example was followed by the government in presenting its proposed foreign investment measures. Canada informed the United States well in advance and at the highest level. This approach has enough flexibility to allow the American point of view to be taken into consideration. Modifications can still be made to the Canadian policy if necessary. More importantly, it allows Canada to test the strength of the American reaction. If the United States indicated that the Canadian policy would result in counter-measures the Canadian government would have the opportunity to reconsider, and possibly to modify its decision or, if it committed itself anew, to prepare itself for the United States adverse reaction.

When, for one reason or another, advance consultations are impossible, the government should ensure that the United States receives "prior notification" of its policy measure. In this case the policy decision is considered rigid, the timing for the announcement is fixed. Nevertheless this process of notifying the United States before a public announcement may be of crucial importance to the relationship. No government likes to be taken by surprise by a totally unexpected announcement on an action which it considers detrimental to its national interest. The element of surprise invariably provokes irritation and may lead to hasty and ill-considered overreaction. The United States is in a position to lean heavily on Canada and reaction could be swift, harmful and difficult to reverse. If the United States government is given at least some warning it has time to cool off, to reflect on the longer-term common interests both countries share and to work out a reasoned reaction which may somewhat assuage its domestic critics who could be affected by the Canadian decision. The Committee considers that no benefit is derived from presenting the United States with a *fait accompli* which will affect it adversely.

The Canadian government deserves similar treatment and the Committee hopes that the commitment to advance consultations and prior notification techniques are resolute on the American side. However, the United States has world-wide preoccupations and responsibilities and Canada is not its only important relationship. As an American witness Mr. Rufus Smith admitted,

"There is always the danger that the U.S. will take unilateral action that will harm Canadian interests. There is the danger of the U.S. unwittingly failing to take account of Canadian interests",⁸⁰

In the Committee's opinion it is in Canada's interest to be most diligent in employing advance consultation and prior notification techniques with the United States so that a pattern is established and neither side will take each other by surprise. It must be emphasized however that advance consultations should in no way be construed as a seeking of approval of the U.S. Government before a policy course is determined in Canada.

⁸⁰R. Smith, (5:7)

2. Negotiating Techniques

a) 'Ad Hoc' Negotiating

While consultation techniques, as discussed in the previous section, are basically an exchange of views intended to increase mutual understanding of each other's positions, negotiation on the other hand is a process in which the negotiator is bargaining with a second party in order to reach a mutually satisfactory outcome. In negotiations the side which can offer the most inducements or alternatively impose most deprivations is generally in the stronger position. Successful negotiating is in some degree a function of strength. The constant preoccupation for Canada, as by far the weaker member in a asymmetrical relationship, has been how to bargain successfully with the United States. Negotiating techniques are important in maximizing available advantages or leverage.

Historically Canadian authorities have preferred to deal with the United States on an "issue-by-issue" basis rather than treating a number of issues linked together. In theory this has permitted issues to be dealt with on a one-by-one basis in a negotiating environment free from outside influences. Canada has been concerned that the United States would link issues, whereupon by its sheer weight and the fact that normally it would have relatively less at stake, it would seek to trade one issue off against another, leaving Canada with an outright loss in some areas. Furthermore any linking of issues was seen by Canadians as reducing the possibility of achieving a successful resolution.

This devotion to "issue-by-issue" bargaining may be changing. Certainly in 1971, balance of payments questions and trade matters of various sorts were closely linked. Such linkage may persist at least in the economic field. Currently, energy and resource questions appear to be discussed in conjunction with payments and auto pact questions. The Hon. Jean-Luc Pepin told the Committee that while he recognized some risk in the linking of issues, there were occasions when it might be useful for Canada to negotiate issues in a package. He observed

"there might be some advantage to be gained in packaging, especially when the issues are not reconcilable one by one. . . . In the 1971 package . . . there were three main elements in the United States position. There were the Auto Pact, the Defence Sharing Agreement and the Tourist Allowance. But Canada also had irritants in its relations with the United States. They were their anti-dumping procedures, the American selling price, the uranium embargo, the copyright clause . . . Some of these irritants could have been packaged with some of theirs. For example you could have given in on the tourist allowance and they could have given in on the copyright."⁸¹

Canada, said Mr. Pepin, had been quite willing at that time to negotiate a 'package' but insisted it be a balanced package. Secretary Connally on the other hand insisted there should be unilateral Canadian concessions. A stalemate ensued and Canada's counter-package in this instance served as a sort of protection.

⁸¹Pepin, (11:7)

It is clear that the earlier preference for "issue-by-issue" negotiating can no longer be rigidly adhered to. The bargaining method should be selected pragmatically Mr. Pepin suggested, as "a matter of circumstances, a matter of personalities and a matter of expediency."⁸²

It is worth repeating that bilateral negotiations, as opposed to consultations, are usually best handled from the bottom up, beginning at the functional official level. If matters cannot be ironed out at progressively higher levels, there then may have to be recourse to the ministerial level and in rare cases even to the summit for the final determination.

Despite the disparity of size and power of the two countries Canada is not without some bargaining powers. As the government's foreign policy review pointed out in 1970 "in an era of heavy demand for energy or other resources, the cards are by no means stacked in one hand."⁸³ The fact that one-quarter of United States exports and a great deal of American employment in certain areas are dependent on the Canadian market must be a factor in American calculations. While the economic equation is of course heavily weighted in the U.S.'s favour, this interdependence has frequently provided Canada with useful bargaining counters. In the 1960's for instance, during the American payments restrictions, Canadian negotiators were twice successful with their argument in persuading the American authorities that it was in the U.S. interest to grant special exemptions for Canada. Yet another negotiating asset is the vast range of United States economic links, which obliges the Americans to look at any negotiation in terms of its world implications. A major example of this situation working to Canada's advantage occurred in December 1971 when, under the Smithsonian Agreement, Japan and several European states re-valued their currencies upward in relation to the U.S. dollar, a move which also increased Canada's competitive position in their markets. Several American witnesses have also pointed, almost with envy, to the smaller and more cohesive Canadian government structure which allows Canadian officials and ministers to focus in a more concentrated way on problems with the United States. There can be better co-ordination on the Canadian side. Furthermore because of the overriding importance of the United States in Canada's eyes, a high quality negotiating team has normally been considered essential. The United States on the other hand has been busy with commitments all around the globe and cannot concentrate on Canada in the same way.

Sometimes, however, it has not been easy for Canada to find the right negotiating leverage. Such was the case initially when Canada sought to negotiate a new air agreement and found itself unable to budge the Americans. The changing pattern of longer haul flights permitted by jet aircraft had made the short-haul arrangements, agreed to immediately following World War II, detrimental to

⁸²Ibid, (11:5)

⁸³Foreign Policy for Canadians, p. 25

Canadian air interests. Canada sought the right to carry passengers far beyond the “gateway” deep into the United States, in order to gain some of the business of Canadians flying to California, Texas and Florida. As Mr. William Diebold pointed out to the Committee, in a successful negotiation of a bilateral issue there must be mutual advantage. In this case Canada was in effect asking the United States carriers to relinquish their near monopoly of long-haul flights from the Canadian border cities southward, while offering nothing in return. With the Canadian population strung out along the United States border, there was no *‘quid pro quo’* to offer the American carriers. It was essential for Canada to find the negotiating tool which would bring the two sides into a give-and-take mutual gain situation. Various techniques were tried, but it was not until Canada threatened to cancel pre-clearance arrangements at the major Canadian airports that the United States saw the benefit of bringing the talks to a mutually satisfactory conclusion. As Mr. Dupuy the chief Canadian air negotiator told the Committee,

“We established a close connection between a successful route agreement and the maintenance of pre-clearance in Canada and we had assessed the value of pre-clearance for the American carriers.”⁸⁴

Despite the overly-long period of negotiations, this case is illustrative of the realities of give-and-take of bargaining between the two countries.

Recent differences over the Canada-United States Automotive Products Agreement revealed other factors and techniques involved in bilateral negotiations. American demands for renegotiation of the auto pact or removal of the safeguard clauses were among the list of important “trade irritants” under discussion in the fall of 1971 and during 1972. In 1970 for the first time since the pact was signed Canada had a surplus in automotive trade with the United States. The United States considered the safeguard clauses were no longer necessary to guarantee Canadian production levels and urged their removal. Canada argued that the surplus could be a passing phenomenon. At one point in negotiations Canada offered to suspend two of the three safeguards during negotiating sessions and then withdrew the offer. This series of moves illustrated a curious and unexpected device which acts as a constraint on United States negotiators in bargaining with Canada. As Mr. Philip Tresize, an American negotiator of the auto pact, put it,

“It always seemed to me that Canadian negotiators and Canadian ministers were subject to a great deal more pressure from their media and from the press, from the public generally on these issues, than were we and they were more constrained in what they could do. We had relatively more freedom since the issues were less important to our newspapers, to our media and we didn’t have the constant pressure from behind us to get things done or not get things done.”⁸⁵

In a sense the American negotiators were at a disadvantage when the issue was one with such a high political profile in Canada. Canadian negotiators could argue convincingly that public opinion was demanding a certain course of action.

⁸⁴Dupuy, (3:26)

⁸⁵Interview of Jean-Luc Pepin and Philip Tresize, Canada AM, CTV, 28 November, 1974

Although in 1970 and 1971 the auto pact raised problems for the United States, Canada is currently suffering a large auto trade deficit. Conditions on which the original agreement were based have changed considerably and inevitably produced friction on both sides. One technique which might have been adopted originally would have been to include an automatic review mechanism in the agreement itself. A built-in provision for such review after a certain number of years would appear to be a realistic device making unnecessary the unpleasant threats to abrogate the treaty such as have been voiced from time to time in the United States Congress.

In the case of many of the bilateral trade irritants which remained unresolved throughout 1972 and early 1973, officials found another mutually acceptable technique, that of transferring the unresolved issues from a bilateral negotiating framework to a multilateral forum, namely to the Geneva GATT conference. As American officials acknowledged at the time, a Canadian government would find it politically easier to defend 'liberalized world trade' than 'concessions' to the United States. From Canada's point of view, the rationale for going to a larger forum was succinctly put by Mr. Rodney Grey.

"If you are dealing with a dispute and you are going to be in the ring with someone who is ten times bigger than you are, it is nice to have some friends and allies around. It is as simple as that."⁸⁶

But, as Mr. Grey warned, Canada must use this technique cautiously, being careful not to generate ill will by giving the impression that it is ganging up with other countries against the United States.

Reviewing the problems of bilateral negotiating, the Committee concludes that Canada as the weaker member of the North American arrangement must be constantly on the alert to find and utilize the most effective bargaining approach with the United States. The traditional preference for 'issue-by-issue' bargaining can no longer be rigidly adhered to. Economic issues are inevitably becoming linked. Canada should continue to commit its highest quality negotiating teams to the bargaining process. It is important to recognize that successful negotiating means a *quid pro quo*—a mutually advantageous outcome. In tough bargaining situations the right tool or leverage must be sought to bring both sides into a constructive give-and-take mutual-gain situation. In certain long-term bilateral arrangements, a built-in provision for an automatic review might be included so neither side will consider itself unfairly dealt with if conditions change considerably. Occasionally, unresolved issues between Canada and the United States can be transferred to Canada's advantage from the bilateral negotiating table to a multilateral forum. Finally, both Canada and the United States must recognize the constraints as well as the advantages which their interdependence imposes on bilateral negotiations.

⁸⁶Grey, (17:5)

Because of the interdependence of the two nations, Canada has a bargaining advantage stronger than its relatively much smaller population would indicate. Because of its size and economic power the United States could, in any contest of retaliation, damage the Canadian economy much more than the reverse situation. Prime Minister Trudeau pointed out the unconscious constraint when he stated

“The ability of Canada and the United States to wreak vast economic harm on each other is a major factor which ensures the two countries will remain good neighbours.”⁸⁷

Canada should not indulge in the popular game of some smaller nations of twisting the lion’s tail or pulling the eagle’s feathers. While it might be good sport, it could lead to serious repercussions detrimental to Canada’s best interests.

b) Common Fact-finding

An important device which has been used successfully in mitigating or resolving bilateral disputes with the United States has been the technique of common fact-finding as a basis for negotiation. The work of the investigative boards of the International Joint Commission is an excellent example of over 60 years of common fact-finding related to disputes along the border, although it is of course only one aspect of the IJC’s function.⁸⁸

A recourse to the establishment of the facts related to Canada-United States trade balances in 1971 was responsible for cooling down one of the most abrasive issues between the two countries in recent years. Following the application of the Nixon economic measures of August 1971, the United States demanded unilateral trade concessions from Canada based on its figures of a large Canadian trade surplus for 1970. Bilateral negotiations on this issue were stalemated from the beginning as the Canadian trade figures showed a wide divergence from the American statistics. It was at this point, on ministerial initiative, that a new joint official-level institution the Canada-United States Trade Statistics Committee was formed, charged with establishing mutually agreed figures. Fortunately, statisticians on both sides already concerned about the huge discrepancy had done some preparatory thinking on methods which could be used. With the ministerial-level impetus, a process was undertaken which resulted, 16 months later, in the publication of the first reconciled figures on bilateral merchandise trade. The Canadian Chief Statistician at the time, Dr. Sylvia Ostry, emphasized to the Committee that these figures were reached in “a strict atmosphere of scientific objectivity.” Over 10 million figures were involved, the officers of both countries were organized as a single research team and

“the computer was totally apolitical The very procedure adopted was such that no one had an inkling of what was to happen until the very last moment.”⁸⁹

⁸⁷Vancouver Sun, 4 Nov. 1974

⁸⁸See Chapter 5 Part II, for a fuller discussion of the work of the IJC

⁸⁹Ostry, (4:7) session 1974.

The results as published showed the Canadian surplus in 1970 to have been considerably less than had been understood in Washington, although more than Ottawa had calculated. The continuation of the reconciliation procedure and its extension to the balance of payments area will ensure that in future when negotiators sit down across the table, there will be fewer disputes over the statistical facts.

The Committee considers that the recourse to common fact finding has made a notable contribution to the bilateral bargaining process. It is particularly suited to trade and financial statistics, but can perhaps be applied in other areas as well, as has already been suggested.⁹⁰

c) Negotiating Publicly or Privately

One of the perennially-debated questions regarding the negotiation of disputes with the United States has been how much of it should be done in public. Bureaucrats have generally held the opinion that Canada does better with the United States when issues are handled through traditional diplomatic channels. Other observers, proponents of the 'squeaky wheel' tactic, consider that Canada should be wary of dealing with the United States in private because it may not be able to resist American pressures to conform with U.S. policies. For its own protection, spokesmen of this approach argue, Canada should always publicly confront the United States. The argument began when the Merchant-Heeney report of 1965 declared that

"whenever possible, divergent views between the two governments should be expressed and if possible resolved in private, through diplomatic channels."⁹¹

Clearly there are times when any government must, for domestic or moral reasons, speak out and explain its position to its own public on a controversial issue. This action may of course have the additional value of gaining the attention of the American decision-makers. But such action cannot be used too often without affecting the spirit of subsequent bilateral negotiations. Canada would soon be accused of bargaining in bad faith. Professor Peyton Lyon pointed out that if such a course were to be followed frequently,

"the effect wears off and we get the reputation of simply being a tiresome nag. It could even be that we would get the reputation for building up issues. —and the effectiveness of our representations in Washington would be greatly diminished."⁹²

The opportunity for "going public" remains a threat, although one which can be used only once. The public confrontation technique also tends to make the give-and-take of bargaining more difficult with far less flexibility in positions. Professor Lyon

⁹⁰See page 46

⁹¹"Principles For Partnership" p. 32.

⁹²Lyon, (9:8)

observed that it is often to Canada's advantage to negotiate discreetly. "It is a lot easier to make concessions in private, especially if you are the president of a big and proud country."⁹³

The Committee noted the point made by the Hon. Jean-Luc Pepin that there was a growing difficulty in maintaining controversial, discreet negotiations because ministers were increasingly involved in high-profile disputes and "when politicians are involved it is almost impossible for them to operate in secret."⁹⁴

The Committee finds little credence for the idea that the practice of quiet diplomacy has worked against Canada's best interests. As Mr. Dupuy made clear, the fact that the air transport negotiations were held in private did not mean there was not tough bargaining resulting in success on Canada's part. Discussing the process, in that context, he said

"... while we speak of quiet diplomacy, these negotiations were hard. We had some very difficult moments. I once went to Washington prepared to stay for fifteen days with a delegation of eighteen people ... we had to return to Ottawa after twenty-four hours ...

This was a chess game but the reality of our economic relationship with the United States is tough, based on hard economic facts."⁹⁵

It is the Committee's opinion that while occasionally it might prove beneficial to publicize a controversy, better results are more likely to be achieved in the normal give-and-take of private bilateral bargaining sessions. Public confrontation as a Canadian negotiating tool with the Americans would very quickly become counter-productive.

The Committee considers that to guard against public suspicion, all relevant details of formal agreements reached with the United States should be made public as soon as possible so as to permit public examination and parliamentary debate if necessary.

3. Arbitration or Judicial Settlement

During the hearings, an American witness, Mr. Rufus Smith, raised the question of the use of arbitration as another technique to settle difficult disputes between the two countries. He suggested that there were some problems which were becoming urgent, where discussions and negotiations had not resolved anything and where both sides had taken rigid positions. He referred specifically to the problem of delineation of the sea boundaries between the two countries off the east and west coasts. He observed,

⁹³Ibid

⁹⁴Pepin, (11:8)

⁹⁵Dupuy, (3:30, 31)

“... perhaps the time has come, where problems of this sort are concerned, for the two countries to resort to arbitration... It seems to me that it is a sensible and civilized way to solve a problem which can be very difficult politically for both countries.”⁹⁶

It may not be common knowledge that not one of the four salt water projections of the Canada-United States boundaries, on the Atlantic, Pacific and Arctic coasts, has been resolved. Potential disputes over these demarcations could involve the fisheries and oil resources of vast continental shelf areas. One has only to think of how difficult the division of the North Sea area would have been, had it not been settled before oil was discovered there, to appreciate the dimensions of the Canadian-American problem.

In 1973 the United States government suggested to Canada in diplomatic correspondence that the two countries should conclude a treaty, submitting to arbitration two small territorial disputes. These involved, on the east coast, Machias Seal Island and North Rock Island in the Gulf of Maine and, on the west coast, the A-B line connecting Cape Muzon, Alaska with the entrance to the Portland Channel separating Alaska from British Columbia. The urgency arises particularly in connection with the east coast where both countries have a keen interest in the resources of the continental shelf as well as in adjacent fishing areas. Canada has been unwilling to agree to the proposal for arbitration, but very little is known in the public realm about the dispute except that the United States has implicitly claimed ownership of Machias Seal Island, while Canada has for many years maintained a manned lighthouse on the island and claims both ownership and sovereignty.

The Committee recognizes that there is a feeling of mistrust in Canada for the arbitration process, probably based on the fact that some early awards and most notably the Alaskan Boundary Award of 1903 were very favourable to the United States at Canada's expense. Perhaps because of this there have been only three disputes between the two countries referred to an international arbitration tribunal since 1930, namely, the “I'm Alone” case of 1932, the Trail Smelter case of 1935, and the Gut Dam arbitration of the 1960's. Yet an expert in international law from Dalhousie University, Dr. R. St. J. Macdonald, told the Committee that

“from a Canadian point of view, the arbitration experience has been a positive one. A number of politically irksome and technically difficult problems have been settled in an orderly and generally satisfactory manner. The method of arbitration has well served the cause of good relations between Canada and the United States.”⁹⁷

In respect of the particular case of Machias Seal Island, the Committee found it virtually impossible, due to a lack of public information regarding the details of the Canadian and American claims, to judge whether arbitration is called for or not. When the facts are made public there should be a full discussion of it by Canadian lawyers, by the Canadian Bar Association and by legal academics. Neither the

⁹⁶R. Smith (5:7)

⁹⁷R. St. J. Macdonald, (12:5)

Committee nor the witness were able to understand the necessity for secrecy in this case. There is no obvious reason why the public should not know the facts of the dispute. If the negotiating stage in the Machias Seal Island case is indeed exhausted, and the Committee cannot secure the facts to make this judgment, **the government should consider Dr. Macdonald's suggestion that an independent rapporteur should be appointed to clarify the facts, list the claims and report back to the two parties.** It may be that this particular case is a case for arbitration. Inevitably these problems must be faced, they are not going to go away. The Committee considers that if these issues are left unresolved much longer they could seriously damage the future of Canadian-American relations.

While there is an understandable reluctance by government to agree to an arbitration or judicial settlement procedure which has the effect of limiting national options and which might require the surrender or at least the delegation of sovereignty to an impartial body, there are situations in which this may be the only practicable solution. In some disputes, local feelings could run so high that any government might find bilateral negotiating, with its inevitable concessions, a political impossibility. A ruling by an independent tribunal might be a far more acceptable solution than bilateral bargaining to those locally involved. However, the Committee can understand why a government would not wish to commit itself to a comprehensive arbitration process intended to settle every outstanding problem. To keep its options open, the Canadian Government would undoubtedly prefer to make individual judgments as to which disputes should be referred to arbitration.

The Committee concludes that the government should look very seriously at the idea of using the arbitration process or the judicial settlement technique in certain disputes. When all the facts in a given dispute are known and when no further meaningful negotiation seems possible, it is the Committee's opinion that the wisest course might be to go to arbitration or judicial settlement.

Possible Arbitral Machinery

The Committee heard testimony concerning the various mechanisms which could be used in settling disputes by an impartial tribunal. It considers they are worth setting out in the event the arbitral process is used.

Three possibilities emerged:

- a) an 'ad hoc' arbitral tribunal which could consist of several, perhaps three, individuals or a single person, chosen jointly by the two governments;
- b) the regional chamber of the International Court of Justice—a system as yet unused, but for which there is now provision. It could sit in North America and the parties involved would be consulted on its composition; or

c) the International Joint Commission as an arbitral board under Article X. As this process would require a two-thirds vote of the United States Senate, it may be only a remote possibility.

It was clear from Dr. Macdonald's testimony that there were advantages and disadvantages to both a) and b). However the Committee noted the strong case that Dr. Macdonald made for using the regional chambers of the International Court of Justice in certain cases. He explained,

"It is important, I believe, that we in Canada understand fully that it is possible now to use regional chambers of the Court. . . . The power to form chambers consisting of three or more judges for dealing with particular categories of cases is expressly recognized by the statute of the court. The parties are free to recognize that their dispute be heard and determined by a chamber rather than by the full court itself, but any judgment given by a chamber is considered to be a judgment of the court. The chamber system has never been used. . . . Under the new rules adopted in 1972, the parties will be consulted about the composition of an *ad hoc* chamber to deal with a particular dispute. It would be possible therefore, for the parties to a regional chamber—for example Canada and the United States—to choose judges from outside the region, if that was thought to be desirable. In short the system has become sufficiently flexible to permit of an *ad hoc* chamber of the court in theory but an arbitral tribunal in practice."⁹⁸

The Committee agrees that Canada should support the International Court of Justice and "the best way to support the court is to use it."⁹⁹ **The Committee concludes that if the government turns to arbitration in the near future, it should give serious consideration to the regional chamber of the International Court of Justice.**

4. Bridging the Information Gap

(a) The Need to Explain

"Good Canadian-American relations depend ultimately on American knowledge and understanding of Canada"¹⁰⁰

Witnesses before the Committee agreed that the widespread lack of understanding and information about Canada in the United States has aggravated problems between the two countries. It is only when Canadian actions appear to be "anti-American" that the generality of United States citizens becomes aware that Canada is a separate nation with independent and sometimes contrary views. When this happened, the American reaction has often been one of surprise, resentment and bewilderment. The United States for example found it difficult to understand why Canada allowed American deserters and draft dodgers into this country. Such things as the oil export tax, higher gas prices, the cable advertisement deletion policy, the *Time* and *Reader's Digest* case, and the foreign investment legislation have caused

⁹⁸R. St. J. Macdonald, (12:7)

⁹⁹Ibid, (12:9)

¹⁰⁰Dr. Claude Bissell as quoted by R. O'Hagan (14:8)

shock and resentment among many Americans, adverse comment in the United States media and strong protests in Congress.

In many cases this has been compounded by an abundance of misinformation and misunderstanding. Americans often assume that they know Canada well, thinking that after all it is not really different from their own country. Even among influential opinion-makers there remains a resistance to the idea that Canadian interests may not always match those of the United States.

As an increasing number of Canadian policies are now having an impact on the United States, a new challenge is facing the Canadian government. Previously one of the important functions of the Department of External Affairs and the Canadian Embassy in the United States was to try to counter American measures which could have a negative impact on Canada. Now a major task is to try to explain and gain understanding for Canadian policies or actions which might be regarded as inimical to United States interests. The challenge, in the words of the Secretary of State for External Affairs, is one of public diplomacy—to explain to the American people “what Canada is, where it is going and why”.¹⁰¹ It is, the Committee realizes, an enormous task.

How should the government respond? How best can it present Canada’s policies to the American people? To whom should its programmes be directed? the media? the Administration’s policy-makers? Congress? businessmen? the intellectual leaders? students as future leaders? the general public? How should the resources be allocated? Should there be more or less emphasis on speeches by Embassy and consular staff? on publications? TV? radio? academic relations? visits and cultural support? Should the work be concentrated in Washington, New York and a few large centres or should it be activated across the United States?

(b) The Initial Response

The Committee has heard evidence related to the various aspects of the Canadian information programme in the United States. With the “New Look” programme launched in 1973, some progress has been made. The government has identified the problem and put the component parts into operation. For instance, a new emphasis placed on the information work of the consulates allows the hiring of talented and experienced local personnel to help get factual information to the local and regional media and opinion-makers. The considerable increase in time spent by the Ambassador in travelling across the United States meeting newspaper editors, giving speeches, press conferences and radio and television interviews has meant a reaching of previously untouched audiences. The stepped-up Canadian studies programme in conjunction with U.S. universities and colleges will help build a better basis for future American understanding and awareness of Canada. The intensified

¹⁰¹MacEachen, (16:8)

publications programme has won many plaudits from informed Americans especially the quality magazine *Canada To-day/d'aujourd'hui* which is being mailed without charge to 44,000 selected opinion-makers and distributed through the 15 consular posts within the United States. There is also the cultivation of the world's busiest press corps, an uphill job in competition not only with American news but the intensive efforts of other nations of the world many of which spend large amounts of money for the specialized services of professional U.S. public relations and "lobby" specialists. Through its visitors programme, Canada now brings influential media executives, selected academics, White House fellows, federal executives, Congressional fellows and some students to Canada and arranges programmes to match their interests. The Department of External Affairs supports an impressive privately organized programme to bring influential members of Congress to Canada to examine Canadian experience in matters of interest to them as American legislators.

In total, in 1974 the federal government spent \$2.3 million on information work, cultural relations and academic relations programmes in the United States, an increase of \$400,000 from the previous year. Altogether, the stepped-up programme and the increased budget represent a start, but it is still only a start. *Much* more needs to be done to fill this urgent need. As Mr. R. O'Hagan, the senior official in charge of information at the Canadian Embassy stated;

"We must constantly search out opportunities to sell ourselves and to tell our story frankly and persuasively. In doing so we must press against the boundaries of convention and creativity."¹⁰²

(c) Academic Relations

In the field of academic relations, there is still only a handful out of approximately 1500 American colleges and universities which offer substantial Canadian studies.¹⁰³ The major benefits of the academic relations programme are no doubt in the future when to-day's students become tomorrow's leaders. But they are also in the present. As the former Ambassador Mr. Cadieux explained to the Committee, he found that in visiting American regions and cities which had a Canadian academic

¹⁰²O'Hagan, (14:10)

¹⁰³American Universities and Colleges with Canadian studies programmes are: University of Maine, courses offered both at the Orono campus and the Fort Kent campus, Maine; University of Vermont, Burlington, Vermont; North Adams State College and Bridgewater State College of the Massachusetts State College system; St. Lawrence University, Canton, New York; Plattsburg campus of the New York State University system (There are quite a few courses offered at other campuses under the N.Y. State university system); University of Rochester, Rochester, New York; Syracuse University, Syracuse, New York; Centre for Canadian Studies, School of Advanced International Studies, Johns Hopkins University, Washington, D.C.; Duke University, Durham, North Carolina; Western Washington State College, Cheney, Washington; Northwestern University, Evanston, Illinois; Michigan State University, Lansing, Michigan; Yale, New Haven, Connecticut; New Jersey State College, New Jersey. These are universities or colleges which offer a structured programme of Canadian studies usually across several disciplines. There are numerous others with several courses or partial courses or a faculty member involved in Canadian studies which are not judged significant enough for this list. Although Harvard has a chair for Canadian studies it has been vacant for a number of years and there is no Canadian studies programme offered.

study programme, the atmosphere was noticeably more receptive and interested and contacts were easier between the consulate, the local media and the academic world.¹⁰⁴

The Committee was told that other countries put considerably more emphasis on this type of information activity. Canada's budget for academic relations is much too small. The main emphasis is on the stimulation of interest at colleges and institutions through the inauguration of Canadian studies programmes but the only incentives available are offers of some books, films, and speakers and, on occasion, the organization of seminars and conferences. In 1975, in addition, \$50,000 was granted to the Centre of Canadian Studies at the School of Advanced International Studies at Johns Hopkins University in Washington, D.C. Compare this with Japan which, as the Ambassador pointed out, has recently endowed a \$10 million foundation to assist academic programmes and faculty in establishing and maintaining Japanese study programmes in U.S. universities.¹⁰⁵ Canada has no less at stake than Japan in the United States. **The Committee urges that Canada expand dramatically its academic relations programme in the United States.**

(d) The Consulates' Role In Information Activities

The Canadian consulates throughout the United States can play an important role in information activities in the United States. Outside of Washington and New York, local newspapers are much more likely to cover Canadian-oriented events and speeches if they have local sources of information. Consular officers have good opportunities to talk to local business, and professional groups of all sorts. It is important to get accurate information quickly to the media to explain the background of Canadian policy and action.

The Committee recommends that information activities by the consulates should be increasingly emphasized and expanded. Yet for the consuls across the United States this poses problems. Removed from the sources of policy-making, they are dependent on Washington and Ottawa for information on up-to-date policy developments, interpretation and material. Mr. Ray Anderson, the Canadian Consul General in Seattle told the Committee that when Canada takes an action which is unpopular or not understood in his area,

"our problem has become one of getting this information to them as quickly as possible so that when the headlines hit, then over you get to the media, to the people who are making the pronouncements, the people they listen to, so that they have this background information . . . you have to give them the facts so they will understand."¹⁰⁶

As referred to earlier in this report, the consulates are severely hampered in getting up-to-date policy information by a lack of a confidential communications link with

¹⁰⁴Cadieux, (4:22)

¹⁰⁵Cadieux (4:7)

¹⁰⁶Anderson, (14:12)

the Embassy and Ottawa.¹⁰⁷ In the Committee's opinion this is an area of critical importance to the effectiveness of the Canadian explanation and persuasion role in the United States. It recognizes that the expense of installation of such a system would be heavy particularly since new office space and equipment and additional man-hours would be involved. The Committee believes, however, that the government should carefully consider undertaking some measures to increase the capacity of at least some consulates in this field.

One way to encourage consulates in their public speaking activities is to support them with a steady supply of source material and themes for speeches. While some progress has been made in the preparation of "speakers' notes", the newly enlarged consulate information staffs could, with the consul, make use of more up-to-date material of this sort. To this end, the Ottawa information staff or perhaps the embassy in Washington should be equipped with creative writers and policy analysts to keep abreast of relevant developments and prepare and distribute a flow of basic material to the consulates where it can be given local flavour and used as required.

(e) Help from Ministers, Parliamentarians and the Private Sector

Another technique for pursuing the goal of explaining Canadian viewpoints or new policy initiatives to Americans is increased speech-making in the United States by informed Canadians including Cabinet ministers. After the initial shock of the Nixon measures of August 1971 Canadian Cabinet ministers made a concerted effort to explain to selected American audiences why Canada felt it had been unjustly included and why it should not be forced to revalue its floating dollar or give unilateral trade concessions. Recently there has been a more deliberate programme by ministers speaking to businessmen, editors, bankers etc. to explain the 'third option' policy as well as recent energy and investment policies. The Hon. Jean-Luc Pepin told the Committee that he had found among United States business groups a disturbing interpretation of certain Canadian policies. He considered that, "we have obviously a lot of straightforward, friendly, calm explanations to give."¹⁰⁸

Although ministerial visits usually do not make headlines in the United States they are another direct method of putting across the Canadian viewpoint to American opinion-makers and leaders and of getting some feed-back from them as to their reactions or apprehensions about Canada. A Cabinet minister can usually be assured of a receptive audience; for example, the Minister of Finance could talk to business, the Minister of Energy to oilmen, the Minister of Agriculture to farmers, the Minister of Labour to a union convention.

The Committee heard testimony from the Secretary of State for External Affairs recounting his 1975 ministerial visits to New York and Boston to explain the

¹⁰⁷See page 24.

¹⁰⁸Pepin (11:14)

“third option” policy to key audiences. Mr. MacEachen stated he felt confident his visits had

“softened some of the shadows which may have arisen due to misunderstanding over certain government policies . . . These presentations bring an awareness of Canada to every region in the United States. These visits direct the increasing attention of important Americans to Canadian affairs by bringing spokesmen for our policies to their door.”¹⁰⁹

While this technique can assist in explaining Canada to Americans it could be dangerous if ministers use it for internal political purposes, that is, to gain domestic political support through extensive newspaper coverage by being abusive or highly critical of American positions. It could also prove useless or counter-productive if such a platform is used gratuitously by ministers to criticize the attitudes and policies of the other country. Ministerial speeches should be used to explain, and to clarify. They should not be used to take “cheap shots” at the Americans. Canadians need only think how resentful they would feel if the U.S. Secretary of Agriculture or of the Treasury were to come to Canada to talk to Canadian audiences in critical terms about a beef import quota or the foreign investment policy and commented critically on internal Canadian problems. There is an unfortunate tendency in Canada to view the United States with a double standard. Canadians seem to feel their ministers speaking in the United States can tell Americans what is wrong with their policies. They can say what they wish in the United States while they resent intensely an American speaking critically of Canadian policy particularly while in Canada. To ensure that the speaking opportunities for ministers are fully productive, a procedure might be applied under which ministerial speeches in the United States should be submitted to the Department of External Affairs for its observations.

The Committee considers that there is a definite need to continue the present government programme of having key ministers give speeches to selected American audiences explaining and seeking understanding for Canadian policies which have an impact on the United States.

In addition to ministers’ information efforts in the United States, there are other sources from which help could and should be sought in making Americans more aware of Canada. Pointing to the many American associations or organizations which have their annual meetings in Canada, the Hon. Jean-Luc Pepin suggested that,

“Members of Parliament, Senators, distinguished back-benchers of the House should accept invitations to speak to them and even ask for them in order to express Canadian views.”¹¹⁰

The former Canadian Ambassador emphasized the importance of people-to-people contact involved in Canadians speaking in the United States. He mentioned the

¹⁰⁹MacEachen, (16:18)

¹¹⁰Pepin (11:13)

possibility of developing this technique at the university level, and of augmenting, in some manner, the Canadian clubs in the United States to help with the Canadian information programme.

In the private sector, a few groups are already making substantial contributions to educating and informing the United States about Canada. The Committee is aware particularly of the work of the Canadian-American Committee¹¹¹ in presenting and analyzing the facts of the relationship in its publications; the campaign organized by the Canadian Export Association to persuade U.S. businessmen that trade with Canada brings great benefits to both countries; the visits to the United States for Canadian businessmen organized by the Canadian Institute of International Affairs; and the furthering of Canadian studies in the United States by the Association for Canadian Studies in the United States. In addition there are a few leading businessmen who participate in binational meetings of associations and groupings and try to explain the Canadian perspective. Such institutions and individuals are performing a very important role, but as Mr. Pepin stated it is always the same businessmen who contributed “systematically and courageously” to this process.

The Committee concludes that there are a number of informed private sector Canadians and Parliamentarians who could participate more actively than they do in this important information and explanation process. From time to time the Department of External Affairs, through its embassy in Washington and its consulates in the United States receives requests for speakers from interested United States groups or associations. **The Committee recommends that the Department attempt to promote opportunities for increased numbers of experienced and knowledgeable Canadians to take part in this programme. At the same time the Committee urges the private sector to respond more fully and positively in recognizing the opportunities and responsibilities involved.**

(f) The Visitors' Programme

The visitors' programme appears to the Committee to be an area which could also be usefully expanded. As Mr. O'Hagan explained, this programme brings influential Americans to Canada. He stated

“One has no difficulty imagining the results that derive from a regular and larger flow of educators, business leaders, academics, artists, professionals of all disciplines, public administrators and, especially, political people at all levels.”¹¹²

While such events as Expo and the Olympics help in drawing American recognition and visitors to Canada, groups of specialists can be offered carefully structured visits

¹¹¹A study group of business, labour, agricultural and professional leaders from both countries whose work is sponsored by two nonprofit research organizations—the National Planning Association in the United States and the C.D. Howe Research Institute in Canada.

¹¹²O'Hagan (14:10)

to present a more substantive Canadian image. Unfortunately, as the Director-General of Public Affairs in the Department of External Affairs told the Committee, the numbers which could be involved are limited by Canada's capacity to receive and look after this type of visitor.¹¹³ **Although the Committee considers that the quality of such a programme is more important than the quantity of visitors received, it recommends that the whole programme be expanded.**

(g) Stepped-Up Information Work with Congress

In line with the deep concern expressed earlier that the need for a much closer liaison with Congress was essential, the Committee is convinced that more attention should be paid to getting factual information about Canada to Capitol Hill. It recognizes that this is not an easy task. While the embassy publication *Canada Report*, which seeks to explain authoritatively controversial Canadian policies is a good effort, it is clearly inadequate for the job although it may be useful to some Congressional staff. A typical Congressman's mail basket like that of his Canadian counterpart overflows with an endless stream of brochures, press releases, booklets, promotional flyers, leaflets and pamphlets making it an awesome task to winnow through, even for the most discerning staff member or Congressman. For this reason, published material is of relatively little value if it is not read. Initial approaches to Congress have to be made on a person-to-person basis. Personal links have to be developed carefully over a considerable period of time so that when issues crop up that need direct explanations, a channel will be available to an important Committee, and interest developed in any supplementary written material.

The Committee is concerned that such contact is minimal at present. How much information work for example has the embassy done in Congress in putting across Canada's and Manitoba's opposition to the Garrison Diversion project in North Dakota? This is an area where the U.S. Bureau of Reclamations is busily bolstering its case for the project in Congress. But has Congress been getting the Canadian side of the story? The same question could be asked in respect of other border irritants such as Point Roberts or the Skagit flooding or Great Lakes pollution. If the federal government does not move in this area, the Committee foresees that the provinces, out of desperation, will. Such a multiplication of the Canadian voice could become very dangerous to Canada's international image.

Another case in point is the auto pact trade figures. While numerous outspoken Congressional leaders knew in 1972 that the balance of automotive trade had been in Canada's favour by \$230 million in 1971, how many Congressmen know that it was in the U.S. favour by \$1.3 billion in 1974? Has the embassy the facilities to put these figures across to the members of the Ways and Means Committee? Has the embassy the personnel and budget capacity to contact those Congressmen who are currently

¹¹³Reid, (14:6)

protesting Canadian cable advertising deletion regulations or Canadian oil and gas export prices and to present them with the Canadian side of the issue?

The Committee considers that a more vigorous government information programme with the Congress is a matter of prime importance and should be pursued in the context of a closer liaison in general with United States legislators.¹¹⁴

(h) Funding Canada's Information Programme

As pointed out earlier, the Canadian government spent \$2.3 million in 1974 on information programmes in the United States. This is dramatically less than other major trading nations such as members of the European Community, Japan or the U.S.S.R. spent in this regard.

The following is an example of what several Western European countries spend on a *per capita* basis in these areas as compared to Canada:

European countries—world wide—\$7.00 per capita;
Canada—world wide—.45 per capita.

European countries—U.S. only—.63 per capita;
Canada—U.S. only—.10 per capita.

The same comparisons, when related to gross trade figures, are even more startling.

European countries—world wide—\$1 per \$230 of trade;
Canada—world wide—\$1 per \$4800 of trade.

European countries—U.S. only—\$1 per \$200 of trade;
Canada—U.S. only—\$1 per \$18,000 of trade.¹¹⁵

The figures for Japan and the U.S.S.R. approximate those of the European countries.

It is true that Canada has certain advantages vis-à-vis the United States in terms of proximity and language and unlike Germany and Japan has not had to overcome the unfavourable image from the war years. Nevertheless, as the Committee heard repeatedly during its study, there is widespread unawareness, disinterest and misunderstanding of Canadian viewpoints and policies in the United States. *Much* more needs to be done by Canada to combat this. As Dr. Claude Bissell stated

¹¹⁴See section 6, pages 46-49 above.

¹¹⁵The above figures are approximate only and the figures for "European countries" are averages of three large members of the EC so as to respect confidential information.

in the words quoted at the beginning of this chapter, the climate of Canadian-American relations is directly related to American knowledge and understanding of Canada.

The Committee realizes fully that it is recommending very substantial increased government expenditures at a time of fiscal restraint, but it is here dealing in priorities not total expenditures. Surely no other country has as much at stake as Canada in protecting its relationship with the United States. As we have already pointed out Canada-United States trade both ways amounts to over \$42,000,000,000.00 annually. Even a small portion of this must not be placed in jeopardy for want of proper attention particularly now when Canada faces a balance of payments deficit approaching \$5,000,000,000.00 per year on a world basis. To repeat an old military maxim we must reinforce strength not weakness and reallocate federal government resources as productively as possible in this area.

The Committee therefore urges the Government to give the highest possible priority to its information, cultural and academic relations programmes in the United States. In order to implement this proposal the Committee recommends that a departmental task force be set up to assess the financial requirements and to decide how best to strengthen the programmes.

This report is the first in a series of reports by this Committee on Canada-United States relations. The next phase of the study will deal with Canadian Trade Relations with the United States.

SUMMARY
of
CONCLUSIONS AND RECOMMENDATIONS
of
VOL. I OF REPORT ON CANADA-UNITED STATES RELATIONS
“THE INSTITUTIONAL FRAMEWORK FOR THE RELATIONSHIP”

Part I

A. Introduction

This report, the first in a series examining various aspects of Canada-United States relations, **deals only with the institutional framework through which relations between the two countries are conducted.** While the report examines mainly government-to-government contacts, the Committee recognizes that the intensive interchange which takes place in the private sector is of enormous significance and constitutes one of the basic strengths of the relationship.

B. The Range and Scope of the Relationship

Geographical and historical forces have moulded the relationship between the two countries helping to create social and institutional parallels and an easy mingling across the border of the two peoples. In almost every field including trade, finance, investment, energy, labour, environment, defence and culture, the two nations have developed close ties which have brought with them a high degree of interdependence.

C. The Changing Concept of the Relationship

In recent years the Canadian-American relationship has undergone a change due partly to internal and partly to external factors. The result has been that Canada no longer seeks, and the United States is no longer willing to grant, special treatment or special exemptions to Canada. Nevertheless in the light of the close geographic ties, the affinities and easy mingling of the two peoples, the similar institutions, similar life-styles, the ease of communication and the extent of trade, there is no doubt that a “special”, in the sense of “unique”, relationship still exists between Canada and the United States.

D. Current Problems

The problem areas between the two countries are increasing both in number and complexity. Not all the complaints are on the Canadian side as many Canadians seem to think.

The Committee has listed some of these current problems. The list serves to illustrate the importance of the subject to which the present report addresses itself, namely, the mechanisms and channels by which Canada and the United States conduct their relationship. With such a range of complex issues to be dealt with continually by the two countries, it becomes of increasing importance to ensure that the best channel of communication is used and that the most effective technique for negotiation is employed and that there is careful co-ordination of approaches in different policy areas.

In recent years in Canada there has been a rising nationalist concern especially over American control of the economy. In the Committee's opinion there is a danger that a nationalist climate can affect, detrimentally, how Canada approaches some of the current problems between the two countries. **The Committee considers that the Canadian government must ensure that difficult bilateral problems are handled in as balanced and mature a fashion as possible. There should be a continual awareness by government of the danger of an over-response to nationalist sentiment in its decision-making. It should try to set a constructive tone conducive to co-operation and problem solving.**

Part II CHANNELS OF COMMUNICATION

1. Summit Contacts

Summit meetings between Canadian Prime Ministers and American Presidents are valuable symbolic demonstrations of the two countries' friendship. They should not be held too frequently nor should they be thought of as a mechanism for negotiation of serious bilateral problems demanding complex solutions. There are occasions however when summit meetings can break a stalemate which may have developed at lower levels.

In making speeches in each other's country, leaders should beware of appearing to tell the other country how to run its affairs.

No Canadian Prime Minister has ever addressed the U.S. Congress although heads of governments from many other countries have done so and American

Presidents usually address the Canadian Parliament. **The Committee urges the government to explore the possibility of a future address to Congress by a Canadian Prime Minister.**

2. Ministerial Contacts

There are risks as well as advantages in the increasing number of one-to-one contacts at the ministerial level between Washington and Ottawa. They can help speed up the decision-making process and cut through bureaucratic red tape but if personalities clash such contacts are better left to the official level. Ministers should be well-briefed, careful not to make commitments the government cannot honour and wary of losing sight of the broad dimensions of an issue through a specialized single department perspective.

In view of the importance of the Canada-United States relationship, a relationship which is in some respects of more importance to Canada than all its other external relations combined, **the Committee recommends to Cabinet that some mechanism be worked out to ensure that all Cabinet memoranda are assessed in the light of the effect, if any, policy proposals would have on Canadian relations with the United States.** This would help prevent an unintentional impact on the United States of Canadian domestic policies and promote the assessment of policies in terms of the broader implications for Canadian-American relations.

Joint Ministerial Committee meetings have in the past provided an antidote to departmental "tunnel vision" but unfortunately the value of these meetings diminished greatly as the structure grew more formal and rigid, as public anticipation compelled publicly announced solutions to complex problems and when it became increasingly difficult to assemble eight or ten busy U.S. Secretaries and Canadian Ministers together for two or three days. **The Committee has concluded with regret that this joint institution, in the structured form it has recently taken, serves no constructive purpose and may even be counter-productive in the conduct of relations between the two countries.**

3. Official-level Contacts

The principal Canadian institutional mechanisms for bilateral contacts at the official level are the Department of External Affairs, the Canadian Embassy in Washington and the Canadian Consulates scattered across the United States. There is also a multitude of regular contacts between officials of functional departments in the two capitals, as well as contact at multilateral conferences.

In order to achieve a broad focus on the relationship which is now lacking **the Committee suggests that the government explore the idea of joint meetings at the**

Canadian deputy minister—U.S. deputy secretary level. The meetings should be unstructured, informal and called on an 'ad hoc' basis whenever either side considers such a meeting might be useful.

The Committee emphasizes the need for effective policy co-ordination at the official level. It considers that there is no alternative to using the traditional channel, the Department of External Affairs, as the central co-ordinating mechanism, but there is also a responsibility on the part of the functional departments to assist in this process by keeping External Affairs fully informed on all aspects of their dealings with the United States.

4. Provincial Contacts or Involvement

The provinces are involved, directly or indirectly, in Canadian-American relations at three levels: through province-state contacts, via the federal government machinery with Washington and within the framework of an international conference where Canadian-American issues are being worked out. At the province-state level there is a multitude of administrative-type agreements, arrangements and understandings worked out across the border without the involvement of either federal government. Careful judgment should be exercised by provincial authorities in assessing whether the problem they are dealing with is likely to become an international issue, in which case the federal government should always be involved.

The Committee suggests that where there are extensive relations with a neighbouring state involving difficult problem areas, the provinces should consider assigning to a provincial government official the responsibility of overseeing the relationship. The provinces should keep the federal government informed of its administrative agreements, arrangements or understandings with American states, and of any official visits to the United States of provincial ministers or their senior officials.

The 'provincial interests officer' at the Canadian Embassy in Washington and the 'information flow system' which has been established to provide interested provinces with relevant information concerning United States' developments is a positive step forward in coping with the problem of provincial involvement in Canadian relations with the United States government. **The Committee suggests that the process might be improved if the Canadian Embassy officials responsible for provincial interests could spend some time in the capitals of interested provinces in order to become better acquainted with the provinces' perspectives and needs.** In the selected reporting which the embassy is doing for the provinces, more emphasis should be put on economic and commercial subjects and less on the traditional diplomatic reporting. **Federal civil servants from Ottawa should be commissioned to spend a period of time in provincial capitals, working if possible in offices concerned**

with intergovernmental affairs in order to be better able to understand provincial problems and perspectives in the foreign affairs field. A federal programme called *Interchange Canada* is already in place under which such an exchange could be worked out.

Inversely, **provincial officials could gain a better understanding of the federal services available in Washington if they spent a week or two at the Canadian Embassy.** When a province has a particular interest in a specific developing situation, a representative from that province should be assigned to the embassy staff on a temporary basis.

While there have been positive initiatives taken by the federal government to improve the consultation and co-ordination procedures by which the provinces have some input into foreign policy formulation, there are still gaps. Further refinement of the processes is needed. **The Committee considers that the federal government has the prime responsibility for developing suitable mechanisms to involve the provinces in consultation in respect to policies toward the United States where relevant to provincial interests. The Committee also believes that the provinces have a responsibility to equip themselves with a central contact point or channel of communication with which the federal authority can deal on foreign affairs matters.**

5. Special Joint Mechanisms

The Committee recognizes the undisputed successes of the International Joint Commission (IJC) over its almost 65 year history. In the face of more complex problems arising along the border, the Committee makes two recommendations to improve and broaden slightly the IJC's functioning. **The Committee recommends that the IJC should be given the authority on its own initiative to make preliminary examinations or assessments of potential pollution problems along the border in order to point out potential sources of trouble and to suggest to the two governments that a reference should be made.** This would, in effect, constitute a watching brief on environmental problems all along the border. At present the Commission must await a reference from the governments before making an investigation.

The Committee also recommends that the IJC should have extended power to publicize all its recommendations, as it already has in respect to its findings under the Great Lakes Water Quality Agreement. Commission recommendations can only be effective when they are adopted and carried out by the governments and agencies concerned. After submitting its recommendations, the IJC should be able to ask for explanations, when a suitable period has elapsed, as to why no action has been taken.

6. Legislative Channels

For a variety of reasons, the Canadian government has been reticent in developing an active programme of liaison with influential Congressional figures. The Committee learned that other major countries' governments feel much less constrained than Canada by the fact that their ambassadors are accredited to the Executive Branch. Canada may be overestimating the importance of this factor while underestimating the significance of the U.S. constitutional division of powers with the consequential strong role of Congress. Or it may consider that the U.S. State Department is always able and willing to interpret the Canadian position effectively to Congress, an assessment with which the Committee cannot agree. Whatever the reason, American witnesses before the Committee considered that the Canadian Embassy could develop a far more active programme of contacts with Congress in order to ensure that the Canadian point of view is understood.

Recently Congress attained significant new powers particularly in the economic field. It is asserting a vigorously independent attitude in foreign and trade policy matters. At the same time, American witnesses told the Committee that there is a great lack of awareness in Congress of the extent and depth of Canadian-American economic ties. Almost inadvertently, Congressional unawareness or misunderstanding of the Canadian position could cause severe economic or trade dislocations in Canada.

The Committee has concluded that Canada's contacts with Congress have been neglected for too long. The Committee urges the government to provide the embassy as soon as possible with the instructions and the means for a greatly expanded Congressional relations programme.

The Committee considers that no other inter-parliamentary link is nearly as important to Canada as the Canada-United States Inter-Parliamentary Group. **The Committee strongly urges the selection of delegates to the Canada-United States Inter-Parliamentary Group meetings who are carefully chosen as to individual areas of expertise and adequately briefed in order to put Canada's case in the most effective possible manner to American legislators.**

7. The Impact of Resolutions of Parliament

Quite apart from its legislative role, the Parliament of Canada can act in ways which may have an impact on Canadian relations with the United States. In recent years there have been a number of Parliamentary resolutions critical of American activities or policies passed by unanimous consent. The government, for a variety of reasons, was associated with each resolution. Because of differences in the two political systems and the fact that the Canadian system is not widely understood in the United States, there has been, on occasion, misunderstanding of the government's action by the American administration.

While the Committee has no criticism of Parliament for exercising its constitutional prerogative, it considers that it is important for the government, as distinct from Parliament, to consider carefully the effect of its action in such circumstances.

Part III TECHNIQUES FOR CONDUCTING RELATIONS

1. Advance Consultations

In the Committee's opinion it is in Canada's interest to be diligent in employing advance consultation and prior notification techniques with the United States so that a pattern is established and neither side will take each other by surprise.

2. Negotiating Techniques

As the more vulnerable member of the North American relationship, Canada needs to develop and utilize the most effective negotiating techniques possible in bargaining with the United States. The traditional preference for 'issue-by-issue' bargaining can no longer be rigidly adhered to as economic issues are becoming increasingly linked. Canada should continue to commit its highest quality negotiating teams to the bargaining process. In tough bargaining situations it is important to find the right tool or leverage to bring both sides into a give-and-take mutual-gain situation. In certain long-term bilateral arrangements, the inclusion of an automatic review provision after a certain period could be helpful in preventing the build-up of feeling on either side that it had the worst of the bargain. Occasionally unresolved bilateral issues can be successfully resolved at a multilateral forum. Overall, the interdependence of the two countries and the ability of either to cause serious economic harm to the other imposes a restraint on both sides in bilateral bargaining.

The Committee considers, where possible in a bilateral dispute, there should be a recourse to the common fact-finding technique similar to that which was used so successfully in the trade dispute of 1971 and 1972.

The Committee finds little basis for the notion that private rather than public negotiations have worked against Canada's interest. **While occasionally it may prove beneficial to publicize a controversy, better results are more likely to be achieved in the normal give-and-take of private bilateral bargaining sessions.** Public confrontation as a Canadian negotiating tool would very quickly become counter-productive. To guard against public suspicion, all relevant details of formal agreements with the United States should be made public as soon as possible to permit public examination and parliamentary debate if necessary.

3. Arbitration or Judicial Settlement

There may be certain issues between Canada and the United States where negotiations have reached an impasse but where resolution is imperative if the overall relationship is not to be damaged. Certain salt water boundary disputes could fall into this category. The Committee considers that in such cases, it might be helpful if the facts of the case were available to the public for open discussion by Canadian legal experts. Further it suggests that an independent rapporteur could be appointed to clarify the facts, list the claims and report back to the two parties. **Finally the Committee considers that the government then should consider very seriously if the arbitration process or judicial settlement would be the wisest course, rather than leaving potentially explosive issues unresolved.**

If the government turns to arbitration it should give serious consideration to the possibility of using the regional chamber system of the International Court of Justice.

4. Bridging the Information Gap

There is an urgent need to try to counter the widespread lack of understanding and information about Canada in the United States, and to explain the need for Canadian policies or actions which might be regarded as detrimental to American interests. A beginning in this difficult task has been made but only a beginning. *Much* more needs to be done.

The Committee urges that Canada expand dramatically its academic relations programme in the United States. The role of the consulates in information work should be increasingly emphasized and expanded. One method of putting Canada's case across in the United States is by means of public speaking by qualified Canadians. The Committee considers that Canadian ministers should continue their efforts to explain and gain understanding for Canadian policies to key American audiences. **In addition it considers that there are knowledgeable Canadians in the private sector and in Parliament who can contribute to this process. The Committee hopes that whenever possible the Department of External Affairs will seek to facilitate such speech-making activities. The visitors' programme of the Department of External Affairs which seeks to bring informed or influential Americans to Canada should be expanded.**

In line with its earlier recommendations for a closer liaison between the Canadian Embassy and Congress, **the Committee recommends that the government pursue a much more vigorous information programme with Congress in order to gain understanding from this important body for Canadian policies affecting the United States.**

As demonstrated by the startling figures developed by the Committee (see page 73), Canada spends dramatically less than other major trading nations in its information, cultural and academic programmes in the United States. No other country has as much at stake as Canada. **The Committee recommends that the government give a new and higher priority for the funding of the Canadian information programme in the United States.**

“Good Canadian-American relations depend ultimately on American knowledge and understanding of Canada.”

This report is the first in a series of reports by this Committee on Canada-United States relations. The next phase of the study will deal with Canadian Trade Relations with the United States.

Appendix I

A Bicentennial Gift from Canada to the United States

The year 1976 is the 200th anniversary the United States of America. Canada will wish to offer the United States a gift to mark the occasion.

In the Committee's opinion, great care should be taken in the selection of Canada's gift. The occasion is a unique one. The Canadian bicentennial project should be a visible and enduring one which not only present but future generations of Americans will see and enjoy. A substantial amount of money should be set aside for the purpose. If it were a question of a Canadian pavilion in a World's Fair the cost to Canada for a notable display would be in the millions. By comparison, the bicentennial year project is considerably more important to Canada.

The Committee has heard testimony to the effect that the government undertook a cultural programme at the Kennedy Centre in Washington—a project which it has linked to the U.S. Bicentennial. It also understood that Canada would participate in the Centennial Parade of the Roses in Pasadena, California on January 1, 1976 and in the presentation at the East-West football game on January 3.

In themselves, such contributions and programmes are commendable. Large numbers of American television viewers watch the parade and the football game resulting in maximum exposure for the Canadian participation. None of these programmes, however, has a lasting commemorative value which is appropriate for such an occasion.

The Committee understands that Canada is preparing a book which highlights the interaction of the peoples of the two nations and that a Canadian grant to the Centre of Canadian Studies at the School of Advanced International Studies at Johns Hopkins University, Washington has been linked to the bicentennial year. The Committee is unaware, however, of what Canada's major presentation will be to mark this important anniversary.

The Committee recommends that the government give urgent consideration to this problem of an appropriate bicentennial gift to the United States. The Committee wishes to emphasize the desirability of a permanent and lasting quality to such a gift and the need to choose something which will stand as a visible and constant reminder of Canada to the people of the United States.

Appendix II

STANDING SENATE COMMITTEE ON FOREIGN AFFAIRS

(1974-1975)

<i>Issue Number</i>	<i>Date of Meeting</i>	<i>Witnesses Heard</i>
<i>(Second Session—Twenty-ninth Parliament (1974))</i>		
1	March 28/74	<i>Department of External Affairs—</i> Honourable Mitchell Sharp, Secretary of State for External Affairs; Mr. Keith MacLellan, Director of U.S.A. Division.
2	April 3/74	Mr. William Diebold, Jr., from the Council on Foreign Relations, New York, U.S.A.
<i>*In Camera</i>	May 1/74	Dr. Arthur J.R. Smith, President, Conference Board in Canada, Ottawa, Canada.
3	May 2/74	Professor Harry Johnson, Professor of Economics, University of Chicago, Chicago, U.S.A.
<i>**In Camera</i>	May 8/74	<i>Department of External Affairs—</i> Mr. Michel Dupuy and Mr. Ralph E. Collins, Assistant Under-Secretaries of the Department. <i>Department of Transport—</i> Mr. E. Butler, Senior Executive, Policy Planning and Major Projects; Mr. J.E. Seal, Policy Adviser, Atlantic Region; and Mr. A.R. Conboy, Director, Policy Implementation.
4	May 9/74	<i>Statistics Canada—</i> Dr. Sylvia Ostry, Chief Statistician of Canada; Mr. Jacob Ryten, Director External Trade Division; and Mr. E.B. Carty, Special Adviser on Balance of Payments.
<i>*Dr. Smith's opening statement is printed as Appendix "B" to Issue #3 of the next session.</i>		
<i>**Portions of the testimony of the Departmental officials are printed as Appendix "A" to Issue #3 of the next session.</i>		

Issue Date of
Number Meeting

Witnesses Heard

(First Session—Thirtieth Parliament (1974-1975))

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|-------------|------------|---|
| *In Camera | Nov. 7/74 | Mr. Willis Armstrong, Washington, D.C., former Senior Official of the U.S.A. State Department, presently a consultant to United States Council of the International Chamber of Commerce. |
| **In Camera | Nov. 28/74 | Mr. Robert B. Bryce, Ottawa, Canada, former Clerk of the Privy Council. |
| 2 | Dec. 5/74 | Mr. Robert J. Schaetzel, Washington, D.C. former United States Ambassador. |
| | | <i>Note: Also included are Appendices "A" and "B"—the testimony of Messrs. Armstrong and Bryce respectively.</i> |
| 3 | Dec. 12/74 | Mr. H. Ian Macdonald, Toronto, former Deputy Minister of the Department of the Treasury and Economics and Intergovernmental Affairs of the Province of Ontario. |
| | | <i>Note: Also included are Appendices "A" and "B"—portions of the testimony presented during the past session of Parliament by Senior Departmental Officials and by Dr. Arthur Smith, respectively.</i> |
| 4 | Jan. 23/75 | Mr. Marcel Cadieux, Washington, D.C. Canadian Ambassador to the United States. |
| 5 | Feb. 4/75 | Mr. Rufus Smith, Washington, D.C., former Deputy Assistant Secretary in charge of Canadian Affairs Bureau, U.S. Department of State. |
| 6 | Feb. 18/75 | Professor Maxwell Cohen, Ottawa, Canada, Canadian Chairman of the International Joint Commission; and Mr. Lloyd MacCallum, Legal Adviser to the Commission. |
| 7 | Feb. 20/75 | Honourable Richard B. Hatfield, Premier of New Brunswick; and Governor Kenneth Curtis, former Governor of the State of Maine, U.S.A. |
| 8 | Mar. 4/75 | Honourable Jack Davis, Vancouver, B.C., former Minister of Fisheries and of the Environment. |
| 9 | Mar. 6/75 | Professor Peyton Lyon, Professor of Political Science and International Affairs, Carleton University, Ottawa. |

*See Appendix "A", Issue #2

**See Appendix "B", Issue #2

- 10 Mar. 18/75 Professor George Francis, University of Waterloo, Ontario; and Professor Leonard B. Dworsky, Cornell University, New York State.
- 11 Mar. 25/75 Honourable Jean-Luc Pepin, Ottawa, Canada, former Minister of Industry, Trade and Commerce.
- 12 Apr. 29/75 Professor Ronald St.J. Macdonald, Dean of Faculty of Law, Dalhousie University, Halifax, Nova Scotia.
- 13 May 13/75 Dr. Gerard Rutan, Director, Canadian and American Studies Program, Western Washington State College, State of Washington, U.S.A.; and Dr. Walter Young, Chairman, Department of Political Science, University of Victoria, British Columbia.
- 14 May 15/75 *Department of External Affairs—*
Mr. Patrick Reid, Director General, Bureau of Public Affairs;
Mr. L.R. O'Hagan, Minister-Counsellor (Information) Canadian Embassy at Washington, D.C.;
Mr. R.C. Anderson, Consul General of Canada, Seattle, State of Washington, U.S.A.; and
Mr. Allan Roger, Director of Information Division.
- 15 May 22/75 Mr. Alan Hockin, Toronto, Vice-President of Toronto-Dominion Bank; and
Dr. David Abshire, Washington, D.C., Chairman, Center for Strategic and International Studies.
- 16 June 10/75 *Department of External Affairs—*
Honourable Allan J. MacEachen, Secretary of State for External Affairs;
Mr. Basil Robinson, Under-Secretary; and
Mr. Glen Shortliffe, Director, United States Division.
- 17 June 25/75 Ambassador Rodney De C. Grey, Head of the Canadian Delegation to the GATT (*General Agreement on Tariffs and Trade*)

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Canada- United States Relations

VOLUME II Canada's Trade Relations with the United States

THE STANDING SENATE COMMITTEE ON FOREIGN AFFAIRS

Chairman: The Honourable George C. van Roggen

Deputy Chairman: The Honourable Allister Grosart



June 1978



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MEMBERSHIP OF THE COMMITTEE

(21 June, 1978)

THE STANDING SENATE COMMITTEE ON FOREIGN AFFAIRS

The Honourable George C. van Roggen, *Chairman*

The Honourable Allister Grosart, *Deputy Chairman*

and

The Honourable Senators:

Asselin	Hastings	McNamara
Barrow	Lafond	Petten
Bélisle	Laird	Riel
Cameron	Lang	Rowe
Connolly (<i>Ottawa West</i>)	Macnaughton	Sparrow
Croll	McElman	Yuzyk

Ex Officio Members: Flynn and Perrault.

(Quorum 5)

Note: The Honourable Senators Carter and Deschatelets also served on the Committee.

ORDERS OF REFERENCE

Extract from the Minutes of the Proceedings of the Senate, Thursday, November 3, 1977.

“With leave of the Senate,

The Honourable Senator van Roggen moved, seconded by the Honourable Senator McElman:

That the Standing Senate Committee on Foreign Affairs be authorized to examine and report upon Canadian relations with the United States;

That the Committee be empowered to engage the services of such counsel and technical, clerical and other personnel as may be required for the purpose of the said examination, at such rates of remuneration and reimbursement as the Committee may determine, and to compensate witnesses by reimbursement of travelling and living expenses, if required, in such amount as the Committee may determine;

That the papers and evidence received and taken on the subject in the three preceding sessions be referred to the Committee; and

That the Committee have power to sit during adjournments of the Senate.

The question being put on the motion, it was—

Resolved in the affirmative.”

Extract from the Minutes of the Proceedings of the Senate, Tuesday, 20th June, 1978,

“With leave of the Senate,

The Honourable Senator van Roggen moved, seconded by the Honourable Senator McElman:

That the Standing Senate Committee on Foreign Affairs be authorized to publish and distribute Volume II of its Report on Canadian relations with the United States as soon as it becomes available, even though the Senate may not then be sitting.

The question being put on the motion, it was—

Resolved in the affirmative.”

Extract from the Minutes of the Proceedings of the Senate, Thursday, 29th June, 1978,

“With leave of the Senate,

The Honourable Senator Langlois moved, seconded by the Honourable Senator Petten:

That the Honourable Senators authorized to act for and on behalf of the Senate in all matters relating to the internal economy of the Senate during any period between sessions of Parliament or between Parliaments be authorized to publish and distribute Volume II of the Report of the Standing Senate Committee on Foreign Affairs on Canadian relations with the United States.

The question being put on the motion, it was—

Resolved in the affirmative.”

Robert Fortier,

Clerk of the Senate

REPORT
of the
STANDING SENATE COMMITTEE ON FOREIGN AFFAIRS
on
CANADA-UNITED STATES RELATIONS
VOLUME II

“Canada’s Trade Relations with the United States”

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Acknowledgements

In the preparation of this report, the Committee has received the fullest cooperation from witnesses in the business community, labour organizations, various associations, government officials and individuals. This type of study would have been impossible without their informed and frank testimony and the Committee is very grateful for their assistance.

To all members of the Committee I wish to record my thanks, and most particularly to the Deputy Chairman, Senator Allister Grosart, whose wise counsel has helped focus us on the important issues of the inquiry.

The Committee is indebted to the support of the Parliamentary Centre. Peter Dobell and Carol Seaborn provided the continuous effective staff during all stages of the study and the report. The Clerk of the Committee, E.W. Innes has been a source of unfailing assistance. At certain stages of the report-writing phase, the Committee was helped by Professor Keith Acheson and Dr. David Dodge. Walter Duffett undertook to check the statistics.

The Library of Parliament provided assistance through its Research Branch and, through its Reference Branch prepared an index of the proceedings of the Committee on which the report is based. This index is available from the Clerk of the Committee.

George C. van Roggen.

CANADA'S TRADE RELATIONS WITH THE UNITED STATES

I 1. Introduction

This is the second report on Canada-United States relations by the Standing Senate Committee on Foreign Affairs. The first report was published in January 1976 and dealt with the institutional framework for the relationship. This report deals with Canada's trade relations with the United States.

It was recognized that this would be a complex and lengthy undertaking. In addition to examining the strengths and weaknesses of Canada's trade with the United States, the enormous concentration of Canada's trade with that country, involving all sectors of the economy meant that Canadian commercial policy and national economic policy are to some extent encompassed in the study.

The Committee was aware from the beginning that many Canadian industrial sectors were in difficulty. As the hearings progressed, the evidence exposed a far more disturbing situation than had been generally perceived. Fortunately, in the interval, various economic analysts and the media have done much to call attention to these facts. These have been particularly valuable in pinpointing problems in individual sectors.

One of the clearest indicators of trouble was the growing uncompetitiveness of many Canadian industries. Was this a result of serious but temporary problems in Canada's industrial sector, or was it the expression of a more deep-rooted structural malaise? In order to determine the answer, the Committee sought out a series of business and labour witnesses, representing a broad segment of the major industrial categories in the country.* These witnesses were asked to provide comparative data on factors affecting Canada's and their specific industry's competitive position. As a result, the Committee's record of proceedings includes an important collection of statistics on the degree to which certain Canadian industries have priced themselves out of the U.S. market and of commentary on the basic causes.

Clearly, with the wide variety of complex problems involved in Canada-United States trade, there was no possibility that one study could produce a general solution for all sectors. Nor would it have been anything but rash to try to make pronouncements on remedies for specific industries when the details in a situation can change from plant to plant and month to month. This report is an overview and the reader should keep this in mind when reading sections which touch on areas of his or her particular expertise.

In spite of the predominantly bilateral focus to the study, the Committee has taken account of changing international factors which have such an important

* See Appendix 5 for a list of witnesses. In the report, witnesses have been identified in the position they held at the time of the hearings although this may have changed since then.

impact on Canadian-U.S. trade, namely, the formation of large economic trading blocks of which Canada is not a member, the evolving international investment picture, the problems of other major trading partners with high inflation and unemployment rates, and the emergence of efficient low-cost, manufacturing centres in developing countries. These developments have increased the challenges and stresses for Canadian industry and frequently have compounded the problems of trading with the United States. Nor has the warning of the Science Council been ignored that, while comparisons of Canadian industry's performance with that of U.S. industry may be cause for alarm, it is also important to remember that U.S. industry itself has been experiencing a severe deterioration in its competitive and innovative capacities vis-a-vis countries such as Japan and West Germany. This makes the situation in Canada all the more serious.

In summary, the Committee has taken a broad look at Canadian-U.S. trading relations, a closer look at some particular problem areas, and attempted a cross-section assessment of the structure and performance of Canadian industry in relation to the United States. It has tried to ask some hard questions such as whether there is a future for manufacturing in Canada and, if so, in what areas? It has sought to look at both the short-term situation and the longer-term solutions to problem areas.

Recognition and analysis of problems of the Canadian economy must not be confused with despair or negativism. Canada, unlike many countries, is blessed with enormous natural wealth and unspoiled land and water, which together can provide the highest quality of life for its people. Canada is in every way in charge of its own destiny and only requires a collective discipline to reach its full potential. This report is designed to help in making the correct choices.

Food and Energy Sectors Excluded from the Study

Two areas of the economy were excluded from consideration—food production (agriculture and fishing) and energy. In the food production sector, third country markets are far more important than either country's market for sales of major products such as grains. In general, while similar types of agricultural products are grown in the two countries, the United States can, because of a wide range of climate, produce many fruits and vegetables which have a much shorter growing season in Canada or may be unproduceable in the colder climate. This seasonal fruit and vegetable trade creates quite special problems and results in special regulatory provisions. But while the U.S. is a major source of fruit and vegetables, Canada supplies a good deal of fish and fishery products and distilled alcoholic beverages to bring the food products category of bilateral trade into a rough balance. Trade in meat and dairy produce is substantial, but it is complicated by off-shore imports and by the existence of Canadian marketing boards. The latter may deserve a study in themselves. For these various reasons, the Committee set aside this sector, but the basic statistics are set out in Table 1 of the Statistical Appendix.

As for cross-border energy trade, the situation has been changing rapidly in recent years due to actions taken by both Canada and the United States. After the Organization of Petroleum Exporting Countries (OPEC) action of 1973, Canada reassessed its inventory and future needs and announced it would gradually phase

out oil exports to the United States. It has already moved to reduce them. While existing gas export contracts to the United States are being honoured, supplementary exports are closely regulated and no new long-term export licences have been granted since by the National Energy Board. Moreover, prices for both oil and gas have moved swiftly up, not in relation to costs, but to the international OPEC price level. Since the normal energy trade pattern has been massively affected by these extraordinary factors, the Committee decided the energy sector merited a separate study which would look at bilateral trade in coal, electricity and uranium, as well as oil and gas, and probably encompass pipeline arrangements, refining, petrochemicals, exploration and investment.

Nevertheless, this trade represents, in dollar terms, about 15 per cent of all Canadian exports southward. Moreover, the United States ships a significant amount of coal to Canada. The energy trade therefore cannot be excluded when considering the overall balance of payments picture and the effect on the economy of invisible flows. In 1974 Canada netted \$3.9 billion in sales of various forms of energy with the United States. This included refined products, liquid petroleum gases and radioactive ores as well as natural gas, crude petroleum, coal and electricity. By 1977, this had moved to \$3.7 billion. Energy trade statistics are given in Table 2 in the Statistical Appendix. These demonstrate that Canada at present is relying significantly on energy exports to the United States to alleviate its balance of payments problem.

2. Background

Next year, 1979, will mark the 100th anniversary of the introduction of the 'National Policy' of 1879—a tariff policy which has shaped Canada's subsequent commercial and economic development in a major way. Designed to form a protected national market, it was supported by other national policies including the development of east-west transportation facilities and the encouragement of western settlement. Their common aim was to promote national unity and strengthen the new federation to the point where it would be independent of its dynamic and at times acquisitive neighbour.

Whatever its economic benefits, the protective tariff has not had the unifying influence that was hoped for. Instead, it has become a focus of resentment within the western and the Atlantic provinces. The central provinces were seen to enjoy an enormous advantage in producing manufactured goods for the Canadian market behind a protective tariff, whereas resource goods were exported free of duty. The Atlantic and western provinces considered that they—as consumers of high cost, domestically-produced goods and imported products made more costly by the tariff—paid the price of protection, while gaining none of its advantages in terms of tax revenues or employment opportunities. From time to time, Canadian governments have considered a major policy change in the direction of free trade with the United States. In 1911 reciprocal free trade was the main issue in the election campaign. But the basic thrust of the National Policy persists, albeit with periodic changes in the level of tariff protection.

In the early 1930s, largely in response to the U.S. Smoot-Hawley tariff, Canadian tariffs were raised to their highest point. Since 1935 there has been a gradual dismantling and reduction of tariffs through international negotiations, most notably through a series of conferences under the aegis of the General Agreement on Tariffs and Trade (GATT). There remains, nonetheless, a residual degree of protectionism not only in the remaining tariffs of Canada and other countries, but also in a variety of non-tariff measures as well. Together they serve as an important factor influencing the volume and mix of goods traded between Canada and the United States. The current Tokyo Round of the GATT multilateral trade negotiations (MTNs) is committed to further liberalization of both tariff and non-tariff barriers.

In 1974 the United States Congress passed a Trade Act which included a specific authorization for the President to "enter into a trade agreement with Canada aimed at eliminating or moving to eliminate trade barriers between the two countries on a reciprocal basis".* In other words, the U.S. President was empowered to conclude a free trade arrangement with Canada. Such a Congressional initiative directed to Canada might have been expected to stir widespread debate in Canada. The surprise is that the move barely gained public notice. The following year the Economic Council's three and a half year study of Canada's trade strategy, "Looking Outward", concluded that Canada would reap particular benefits in a bilateral free trade arrangement with the United States. While the Council's report aroused some interest and concern in the business community, it was largely ignored at the political and official levels.

Canada's present economic and trade outlook is far from promising and there is no agreement on remedies. The international trading world is consolidating itself into trading blocs. Canada has not joined in this process, and yet such is Canadian sensitivity even to suggestions for continental trading arrangements that the idea of a North American trading unit has not received reasoned public and political consideration. In Canada business and labour circles there is considerable nervousness over the more immediate consequences which GATT tariff reductions might have on their industries. A dramatic increase in Canadian plant investment has taken place in the United States in the past several years as both Canadian-controlled and subsidiary firms have expanded or relocated south of the border. Against this background the Committee decided to give serious consideration to Canada's trading relationship with the United States with the bilateral free trade alternative in mind. Further, the Committee considered that it was appropriate for it as a parliamentary body to respond to the specific resolution directed to Canada by the U.S. Congress.

* U.S. Congress, Official Summary of the Trade Act of 1974, p. 3

II A PROFILE OF CURRENT BILATERAL TRADE

In general terms, trade relations between Canada and the United States at the present time can be characterized as friendly, with none of the rancor and ill-feeling which marked the relationship in 1971 and 1972 in the wake of President Nixon's surcharge. Currently there are few serious bilateral trade issues causing concern between the two countries. This may be due in part to the fact that a number of tariff and non-tariff issues which would normally be dealt with on a bilateral basis are being negotiated at the multilateral levels, in the GATT multilateral trade negotiations in Geneva. In this forum both governments have committed themselves to the objective of further liberalization of trade barriers. Considering the enormous volume, variety and complexity of the trade between Canada and the United States, the trade relations are remarkably positive and bilateral trade continues to expand. In 1977 the value of merchandise goods traded between Canada and the United States was over \$60 billion, more than between any two other countries in the world.

1. The Basic Facts

For both trading partners the trade relationship is of major significance. For the United States, Canada is its most important customer. With only one-tenth the population of the nine European Community (EC) countries, Canada buys as much from the United States as do the EC countries combined and more than twice as much as Japan. Canada is currently a market for over 22 per cent of U.S. exports and a source of 20 per cent of its imports. It is second to the Netherlands as a source of the largest amount of direct investment in the United States. Until very recently, Canada has been the prime location for direct investment by Americans.

From a Canadian point of view, this bilateral trade is of overwhelming economic importance. Approximately 70 per cent of Canadian exports go to the United States and a similar percentage of imports come from the United States. This preponderance of Canada's trade with the United States is in contrast to the 10 per cent of its trade with the European Community, the 5 per cent with Japan and the 15 per cent with the rest of the world which even includes the huge grain shipments to the Soviet Union and China.

At least 15 per cent of the nation's Gross National Product (GNP) is generated by Canada's exports to the United States and one out of every two jobs in the goods-producing industries is dependent on exports to the United States in one way or another. The United States is the largest market for all major Canadian commodity sectors, except agriculture. Bilateral trade in automotive products alone reached \$20 billion in 1977, which was by itself significantly more than Canada's trade in all items with the European Community and Japan combined.

2. Merchandise Trade

A glance at the accompanying charts 1 and 2 reveals the pattern of Canada-United States trade. Detailed statistics for the various trade categories are set out in Table 1 of the Statistical Appendix.

Trade in agricultural products is limited despite the fact that both countries are producers of a wide range of products. After oil and gas, iron ore and concentrates constitute the next most important Canadian export in crude materials, while United States supplies a significant amount of coal to Canada. In this category the dollar value of exports has remained constant in the \$5 billion range during the three year period 1975 to 1977 with the increased natural gas prices masking the volume declines in the petroleum exports. Adjustments in terms of trade have been to Canada's disadvantage since 1975 due to the fact that prices for such important export commodities as unwrought nickel, copper and zinc have not kept pace with the prices of manufactured goods of which Canada is such a heavy importer from the United States.

In the fabricated materials category, three main items of trade stand out; forest products, non-ferrous metals and chemicals. Half of Canada's exports of fabricated materials (17.4 per cent) are in forest products, underlining the importance of these shipments of lumber, wood pulp and newsprint to the United States. Iron and steel and alloys, aluminum and alloys, copper, nickel and zinc metals go mainly from Canada to the United States, while chemicals and chemical products are important U.S. exports to Canada. Fertilizers are the main chemical product which Canada exports to the U.S.

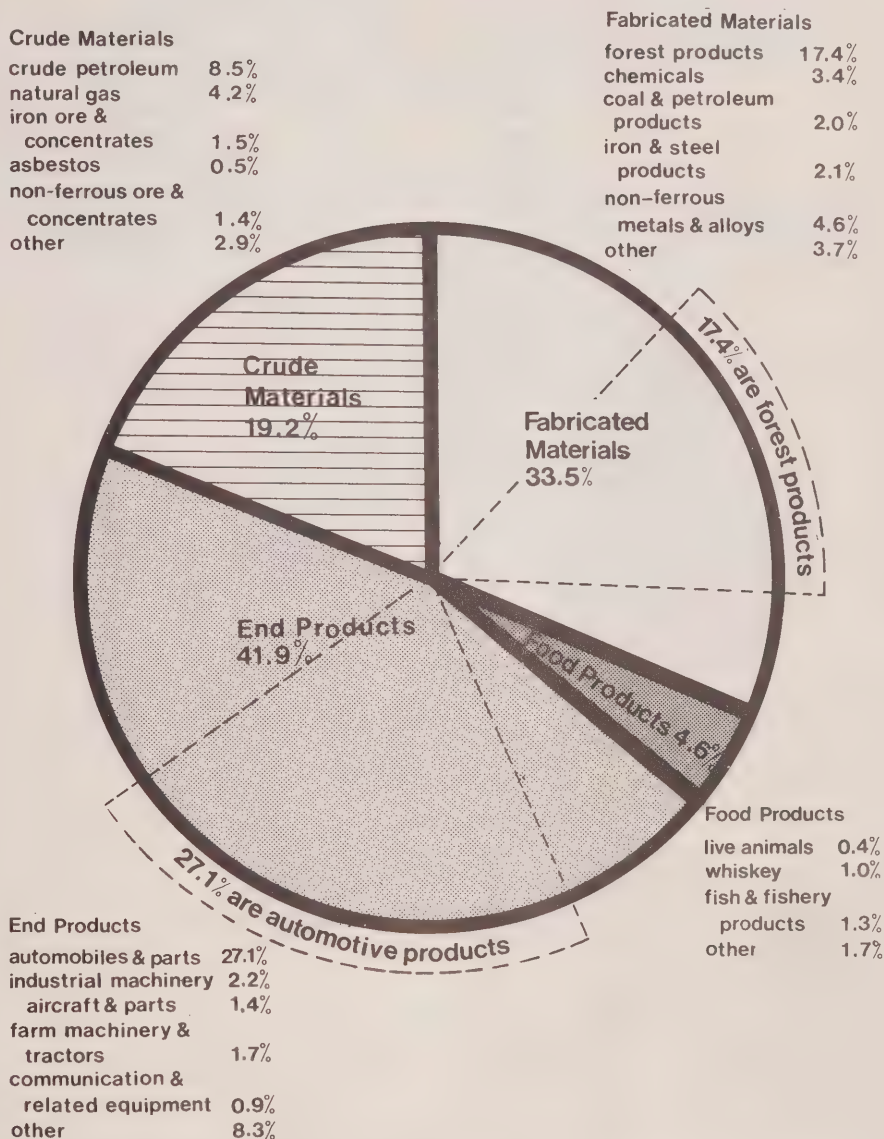
The strong point of Canada's merchandise exports to the United States lies in the fabricated materials category. The value of these exports has risen from \$1.7 billion in 1960 to almost \$11 billion in 1977, giving Canada consistently strong payments balances in this category. In 1976 Canada's surplus was \$3.9 billion and in 1977 it was \$5.9 billion.

In the end-product category, automotive products constitute the principal item traded in both directions, amounting to two-thirds of Canadian exports and close to one-half of U.S. end product imports to Canada. Aside from auto products, the majority of goods exported by Canada in this category are capital goods, such as equipment and machinery of all kinds. While a notable growth has been achieved in Canadian machinery exports to the U.S. in recent years, the level of these exports still constitutes only about one-quarter of the level of imports. The United States supplies a wide range of consumer items and has also become a major exporter of electronic computers to Canada.

The weakness of Canada's trade performance lies in the inability of Canadian end products, aside from automotive products, to counter the increasing flow of U.S. and other imports, which are in many cases displacing Canadian domestic production. While the value of Canadian exports in this category, excluding automotive products, rose impressively from \$271 million in 1960 to \$3.6 billion in 1977, the inflow of U.S. products rose in comparable proportion from \$1.6 billion in 1960 to \$10.3 billion in 1977, leaving Canada with a massive payments deficit of \$6.7 billion

Chart 1

Canadian Exports to United States by Category (as % of total Canadian exports to United States, average over period 1971-77)

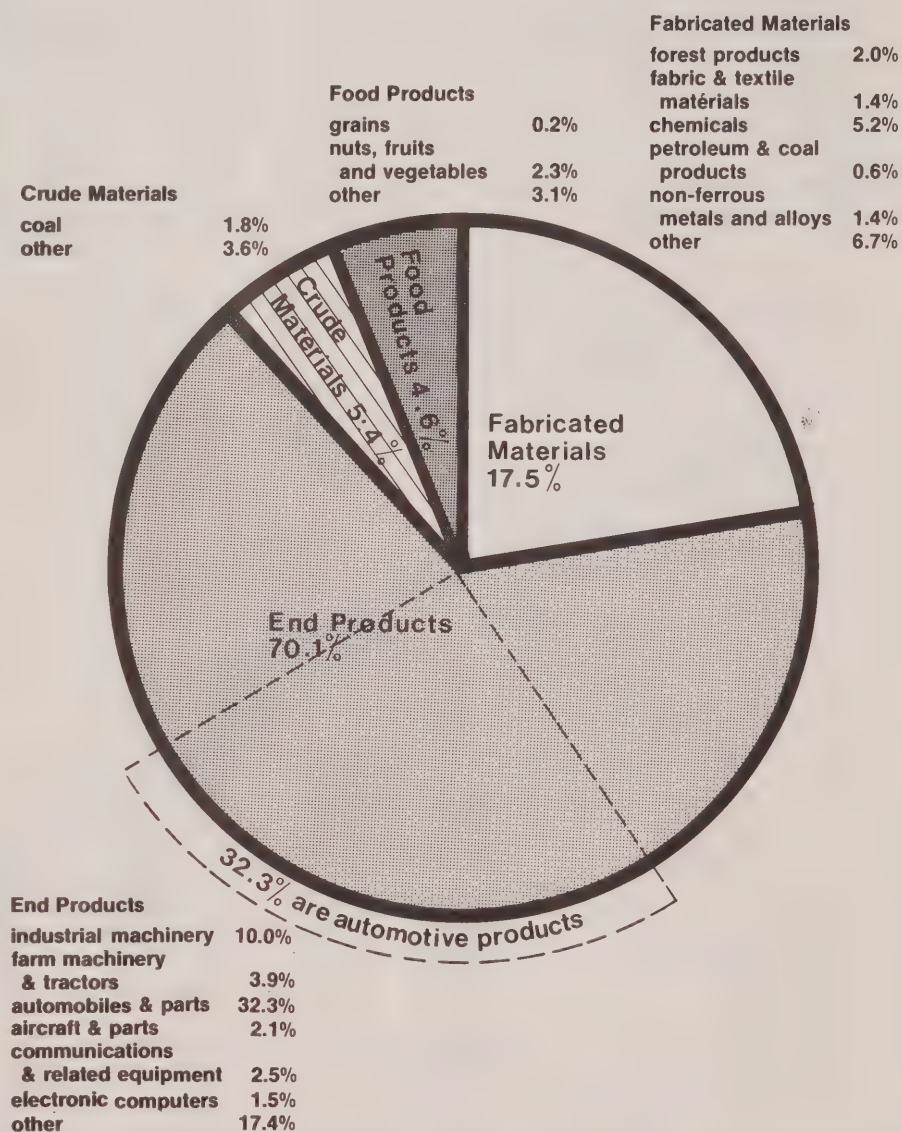


*Percentages for the segments in the main circle do not add to 100 because Special Transactions are excluded. This category includes items such as private donations of goods, settlers' effects and imports for diplomats.

Source: Statistics Canada

Chart 2

Canadian Imports from the United States by Category (as percentage of total Canadian imports from US, average over period 1971-77)



*Percentages for the segments in the main circle do not add to 100 because Special Transactions are excluded. This category includes items such as private donations of goods, settlers' effects and imports for diplomats.

Source: Statistics Canada

in this category. If the deficit in the automotive trade is added to this, the total Canadian deficit is \$7.6 billion in end products in 1977.

It is difficult to find a definite pattern developing in the merchandise trade payments balances between the two countries. In the past 18 years, since 1960, Canada has had a deficit in nine years and a surplus in nine years (Chart 3). The last few years have witnessed wide fluctuations in the bilateral trade balances ranging from a deficit for Canada in 1975 of \$1.8 billion to a deficit for the United States of \$1.3 billion in 1977. Canada has over the years consistently maintained a surplus in crude materials and fabricated materials categories, while the United States has had a steadily growing surplus in the end product trade.

3. Non-Merchandise Trade

Invisibles or non-merchandise trade include items such as receipts and payments for travel, interest and dividends, freight and shipping charges and transfers. Interest and dividends now represent over 45 per cent of Canada's invisibles payments to the United States. These are the result of widespread U.S. investment in Canada over many years and of borrowing by Canadian business and governments at various levels on U.S. money markets. The latter has been particularly heavy in recent years totalling \$2.8 billion net in 1975, an extraordinary \$4.9 billion in 1976 and \$2.5 billion in 1977.

Another component of the invisibles trade which has suffered a deterioration in recent years is the tourist account. Traditionally Canada has had a surplus in tourism with the United States which has helped it balance its tourist deficit with the rest of the world. But 1974 was the last year of surplus with the United States. In 1975 there was a \$250 million deficit, in 1976 it had risen to \$600 million and by 1977 to \$770 million or about 45 per cent of the total Canadian travel deficit.

Canada has consistently had a deficit with the United States on its non-merchandise or invisibles account. This deficit has risen sharply in recent years; in 1975, \$3.7 billion, in 1976, \$4.5 billion and in 1977, \$5.6 billion, compared with \$871 million in 1965 (Table 1). This deterioration reflects both the change from a surplus to a deficit in the travel account and the increased burden of interest and dividend payments mentioned above. The recent borrowings have been made with exceptionally high rates of interest and will raise the level of interest payments dramatically for many years to come. In addition, the 1977 and 1978 decline in the exchange rate of the Canadian dollar vis-à-vis the U.S. dollar has increased the burden of the interest payments.

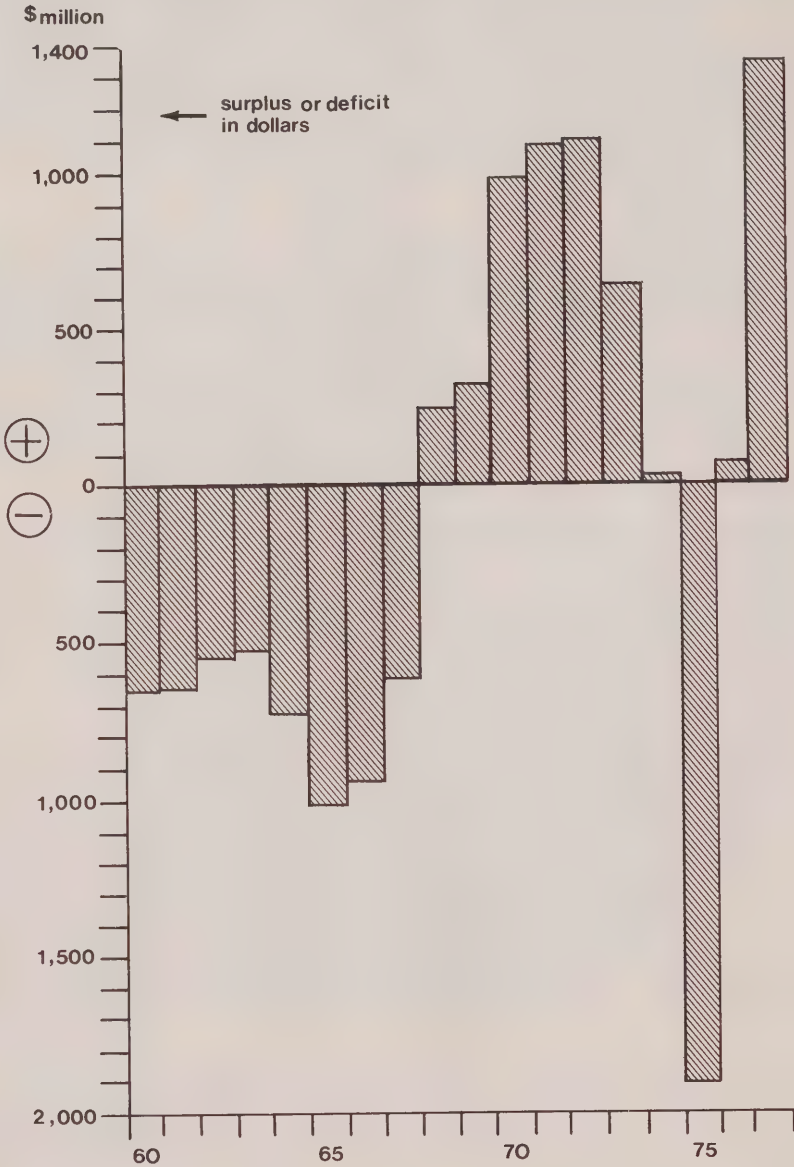
4. Factors Influencing Trade Between Canada and the United States

Tariffs or the absence of tariffs is a most important determinant of trade flows between the two countries.

A large proportion of the trade between Canada and the United States flows freely with no tariff barriers. In terms of the dollar value of trade, the institution of reciprocal free trade under the Automotive Agreement in 1965 has had an enormous impact on the stimulation of this two-way trade which has increased twenty fold

Chart 3

Canada's Balance of Merchandise Trade with the United States



Source: Statistics Canada

(\$ millions)

	Average 1971-77	1976	1977
Receipts			
Travel	1256	1346	1509
Interest & Dividends	458	497	465
Freight & Shipping	837	959	1141
Other Service Receipts	<u>894</u>	<u>1082</u>	<u>1128</u>
TOTAL:	3445	3884	4243
Payments			
Travel	1415	1956	2278
Interest & Dividends	2098	2580	3181
Freight & Shipping	957	1198	1354
Other Service Receipts	<u>2159</u>	<u>2749</u>	<u>3076</u>
TOTAL:	6629	8483	9899
Balances			
Travel	— 159	— 610	— 769
Interest & Dividends	— 1642	— 2083	— 2716
Freight & Shipping	— 119	— 239	— 213
Other Service Receipts	<u>— 1264</u>	<u>— 1667</u>	<u>— 1948</u>
TOTAL:	— 3184	— 4599	— 5646

Source: *Statistics Canada*

between 1965 and 1977, from \$1.2 billion to \$20 billion. Another stimulant has been the Defence Production Sharing arrangement under which defence purchases have been traded, duty free, for almost 20 years. In the farm machinery sector an important amount of trade is duty free under long-standing measures instituted by both sides. In addition, Canada unilaterally permits free entry for machinery of a class or kind not made in Canada. Officials pointed out that due to the special provision in the Canadian tariff which allows for importation free of duty for products not made in Canada, the total value of finished manufactured goods imported duty-free from all countries into Canada, even excluding automotive goods, is higher than the total value of manufactured goods imported duty-free into the United States, Japan and the European Community combined.

In total then, over 60 per cent of U.S. imports enter Canada duty-free. If automotive products are excluded, this figure falls to 44 per cent. About 70 per cent of Canadian exports, including automotive products, enter the United States free of duty; if automotive products are excluded this falls to 57 per cent.

Existing levels of tariffs shape the size and stage of manufacture of each country's exported products. Generally speaking, Canadian tariffs are somewhat higher than those of the United States, but there are a number of peaks in the U.S.

tariffs. The United States has higher tariffs on raw materials and on some semi-processed materials such as non-ferrous metals, nickel, copper, lead, zinc and aluminum than does Canada. While pulp and newsprint face no tariffs either way, trade in paper manufactured products is affected by significant duties. U.S. tariffs on end products are usually lower than Canadian levels. In both countries, considerable protection is provided to chemicals and chemical and plastic products, toys, footwear, clothing and clothing accessories.

In addition, both countries have a range of non-tariff measures including countervail, export subsidies, quotas, government procurement policies and consumer and health standards which affect the trade flow. However, officials told the Committee that tariffs are, at least at present, the more important determinant of conditions of access between Canada and the United States than non-tariff measures. This is not the case in respect to trade with Japan or the European Community where non-tariff measures are a much greater barrier and, if the GATT negotiations reduce tariffs significantly, it will not be the case even with the United States.

5. Areas of Concern

Despite the see-saw of trade balances between the two countries over the last two decades, which might seem to indicate a certain equilibrium of trade flows, a number of specific areas emerged during the course of the Committee's study which appear to be cause for concern to Canada. Some of these problems are well known, others have not been widely discussed. All are having or could have serious future ramifications. Most of these problems relate to Canada's trade performance rather than to specific trade issues or disputes between the two countries. They include:

- the growing Canadian current account deficit,
- the large imbalance of end product trade, including deficits in automotive and machinery trade,
- the deterioration in the travel account,
- the relocation and expansion in the United States of companies including both Canadian controlled companies and U.S. subsidiaries.

a) The Current Account Deficit

In financial terms a problem is posed by the very large Canadian current account deficit with the United States since 1975. The current account surplus or

Table 2
Canada's Current Account Deficit with the United States
(millions of dollars)

<u>1967</u>	<u>1968</u>	<u>1969</u>	<u>1970</u>	<u>1971</u>	<u>1972</u>	<u>1973</u>	<u>1974</u>	<u>1975</u>	<u>1976</u>	<u>1977</u>
—1301	—744	—877	—227	—215	—272	—933	—1632	—4796	—4206	—3940

Source: Department of Finance, Economic Review, 1977, 1978, p. 198.

deficit combines the surplus or deficit on merchandise trade with the surplus or deficit on invisibles. It does not include the balance on capital flows between the two countries. For the last three years, Canada's current account deficit has averaged over \$4 billion. The cause has been the growing deficit in the invisibles or service account. As a result, even in years of large merchandise trade surpluses, such as 1977, the invisibles deficit has been only partially offset. If the merchandise trade account should slip into deficit, as it has done frequently in the past, the current account deficit would mount alarmingly.

b) Imbalance in End Products

As noted above the trade deficit in end products with the United States has grown sharply in recent years. Imports have more than doubled since 1972 whereas exports, while growing rapidly, started at a low base and the absolute gap has steadily widened. The deficit has spiralled from \$2.8 billion in 1972 to a peak of \$8.2 billion in 1975, dropping to \$7.6 billion in 1977.

The imbalance in end products was originally attributed to a weakened demand for Canadian products during the 1974-75 period of cyclical recession in the United States, while imports continued strong into Canada due to a relatively less severe recession. It was argued that when the United States economy improved, demand for Canadian products would pick up. This has not happened. In fact, in 1977, a comparatively good year for the United States, the dollar value of Canadian end products exported to the United States, excluding automotive products, actually declined despite inflated prices. It is evident that the trend in manufactured end products is going against Canada for other more deep-seated reasons.

Two sectors of secondary manufacturing are of particular concern; the machinery sector and the automotive sector. Of these, the latter has received much more attention, but the disequilibrium in the machinery sector is greater and deserves particular notice.

In 1975, Canada's overall deficit in the machinery sector* was \$3.8 billion. With the United States alone the deficit in this sector was \$3.1 billion in 1975, rising to \$3.5 billion in 1976. Compared to this last figure, Canada's 1976 automotive trade deficit with the United States of \$1 billion looks much less disturbing, particularly when it is realized that the \$3.5 billion deficit was on a total bilateral trade of \$5.7 billion whereas the \$1 billion automotive deficit was out of a total of \$20 billion in cross-border automotive trade. Not only the deficits but the trends in machinery trade are also cause for concern. Despite the fact that there has been considerable growth in machinery manufacturing in Canada in the past ten years and an increase in exports, imports are nevertheless taking an increasing portion of the Canadian machinery market, rising from 53 per cent in 1970 to 62 per cent in 1975.

Automotive goods trade between the two countries is by far the largest single item of bilateral trade. Canada has had a substantial imbalance in this trade which

* This includes machinery and equipment used by Canada's resource, processing, and manufacturing industries including mechanical equipment for power generation. It includes agricultural equipment but not electrical and transportation equipment.

has persisted since 1974, with a deficit that year of \$1.2 billion, in 1975 of \$1.9 billion, in 1976 of \$1 billion and in 1977 almost \$1 billion again.

The main problem is the automotive parts industry, in particular the trade in those parts known as the original equipment parts which become part of the assembled motor vehicle, as distinct from after-market parts which are the service or replacement parts available separately. In the parts trade, as distinct from trade in assembled vehicles, Canada's deficit has grown from \$1.9 billion in 1974, to \$2.4 billion in 1975, \$2.5 billion in 1976 and over \$2.9 billion in 1977. While Canadian surpluses in assembled vehicle trade have partly offset the deficits in the parts trade for these years, an overall imbalance remains. Underlying problems are related to a shift in the sourcing of parts by the automobile manufacturers and concern that Canada may not be participating in the unprecedented technological changes and major restructuring which are imminent in this industry.

c) Deterioration in the Travel Account

As noted above a major trouble spot in the invisibles account is the tourism and travel account, with its recent and fast-growing deficit with the United States. In the Canadian economy, tourism ranks with petroleum, minerals, automotive products, forest products and wheat as an important earner of U.S. dollars. Total tourism receipts in Canada in 1976 amounted to \$1.9 billion and 88,000 jobs directly or indirectly are attributable to its operations.

The trend seems to be for fewer Americans to come to Canada, and to come for shorter periods, while at the same time they have been travelling overseas far more than in the past. Canadians, for their part, are increasing their visits to the United States, and at the same time travelling less in Canada. In 1976 for example, there was an increase of 6.8 per cent in Canadian visits southward but an 8.6 per cent decrease in American visits to Canada. Although it was felt at the time that the 1976 figures reflected the pull of the bicentennial celebrations in the United States, the trend persisted in 1977. In that year, U.S. visitors decreased by 1.4 per cent while Canadians going to the United States rose by 5.5 per cent.

Two particular factors are seen as having contributed to these developments: the uncompetitively high Canadian costs in the hospitality industry and the 1977 U.S. legislation which has adversely affected U.S. convention business in Canada.

d) Relocation and Disinvestment

The past two or three years has seen a relocation trend by Canadian producers which has serious implications for Canada-United States trade. A growing number of Canadian manufacturing companies have chosen to locate facilities in the United States, or are contemplating a plant expansion in the United States rather than in Canada. The period of the Committee inquiry was punctuated by media reports in which business representatives explained why Canadian corporations found the U.S. business environment more favourable for investment and expansion than the Canadian. The U.S. Conference Board reported a four-fold increase in the number of new Canadian investment projects in the United States during 1976 as compared to 1975. The exodus continued during 1977.

Figures published by the U.S. Commerce Department show the rise in Canadian investment in the United States. Canada was third after West Germany and Japan in the amount of direct investment in U.S. companies in the first half of 1977; 16 U.S. companies were bought by Canadian interests during this period. Most investments were in U.S. manufacturing industries. Preliminary data for uncompleted acquisitions for the second half of 1977 showed Canada in the lead in U.S. acquisitions.

The relocation or failure-to-expand decisions by U.S. multinationals with subsidiaries in Canada are also showing an unwelcome increase. In 1977 for the first time in the U.S. Commerce Department records, figures show that U.S. parent companies took more funds out of Canada than they committed in direct investment. The net loss for 1977 was \$440 million compared to an annual average net inflow of \$500 million during the past decade.

The recent invasion of the United States by Canadian real estate and development companies constitutes a separate case, not readily comparable with the movement southward by manufacturing companies. Their products are primarily entrepreneurial and organization skills rather than a product to be manufactured. While press reports of assets controlled by large Canadian developers in the U.S. market reach \$2 billion or more, the actual Canadian outflow of dollars when one allows for mortgage financing is undoubtedly much less. Furthermore they do produce an invisible return to Canada.

In analyzing this trend of business expansion southward, it is important to distinguish the underlying rationale behind the Canadian companies' decision-making. It is understandable that successful Canadian companies may, at appropriate times, decide to go multinational and break into the U.S. market through direct investment in subsidiary plants in the United States. Such companies are merely following the proven prescription for efficiency and cost competitiveness, by getting closer to the larger market, and Canada will benefit in most cases from the production of components and from invisibles flowing back. What is alarming is that some Canadian companies have decided, after an assessment of comparative costs of doing business in the two countries, that they can no longer afford to expand their Canadian plants or divert new investment into production facilities in Canada, whereas they can do so in the United States. Companies such as ATCO and Northern Telecom explained to the Committee that they are going to supply off-shore countries from their lower cost U.S. plants rather than their Canadian plants, in order to remain competitive and retain the off-shore markets. Others suggested that they might even find it economic to supply Canadian markets from the United States.

III BASIC CAUSES OF THE PROBLEMS

1. Loss of Competitiveness

The fear that Canada is pricing itself out of international markets, and particularly the U.S. market, was expressed by many witnesses during the hearings. Concern over the declining competitiveness of Canadian industry led the Committee to devote a number of hearings during 1976 and 1977 to explore the reasons and any remedial measures that might be proposed. In the meantime the problem has been documented by a number of other studies and commented on extensively in the media. Some of the detailed analysis prepared by the Committee is published as Annexes A and B to the report.

a) Comparative Wage Rates

Throughout the hearings the most frequently cited concern of the majority of witnesses was the rapid growth in Canadian labour costs, largely brought about by higher wage settlements in Canada than in the United States. Between 1970 and 1976, compensation per hour in manufacturing in Canada increased by 82 per cent compared to 59 per cent in the United States. By mid-1975 the average level of wages in this sector in Canada surpassed that in the United States. In 1976 this trend continued and by the end of that year average hourly earnings in Canadian manufacturing stood at \$5.98 compared to \$5.34 in the U.S.

However, significant differences were reported in individual industries. In forest products, electrical machinery, business forms, and telecommunications equipment, Canadian wages were substantially higher than U.S. wages; in carbon steel and automotive assembly approximate parity existed; in a number of other areas such as auto parts, farm machinery and specialty steels, Canada retained a wage cost advantage.

Simple hourly wage differentials may present a somewhat biased picture of comparative labour costs in the two countries, as there are some basic differences in the bases employed in calculating wage increases. Further, testimony by witnesses indicated that in some industries fringe benefits are more generous in the United States as compared to Canada. For example, Du Pont's management reported that in a similar fibre plant, Canadian wages are 109 per cent of U.S. wages but the total remuneration *including benefits* to a Canadian worker is 98 per cent of the U.S. level. The figures for a similar petrochemical plant are 106 per cent and 95 per cent respectively. Important social benefits which are paid, in part, by contributions from employers in the United States are provided by the state in Canada. In any comparison it is necessary to remember that some part of the higher wages paid to workers in Canada is taxed to help finance these programs.

Despite this, money wages increased so much faster in Canada than in the United States that an unusual combination of forces must have been at work. No thoroughly convincing explanation why Canadian manufacturing wage rates rose so dramatically was presented to the Committee, but several contributing factors were suggested. These factors were in two broad categories: a) those related to the "tightness" of labour markets, i.e., the balance between aggregate demand for and supply of labour, and b) those related to changes in the structure of labour markets such as social security, minimum wages, and unionization.*

The Committee finds that:

- a) The "tighter" Canadian labour market during the period from 1970 to 1975 created upward pressure on wages in Canada relative to the United States. The numbers employed in Canada increased by 19.5 per cent compared to 8.5 per cent in the United States.
- b) Both monetary and fiscal policy were more expansionary in Canada than in the United States from mid-1975 on. The resulting price increases had the effect of accelerating wage demands.
- c) The public sector in Canada expanded much more rapidly in Canada than in the United States from 1970 to 1975, generating increased demand for labour and putting pressure on wage levels. In Canada employment in "public administration" grew at an extraordinary 30 per cent in this period compared to 18 per cent in the private sector. Furthermore, wages in the Canadian public sector were pushed up by a dramatic expansion in the number of public employees covered by collective bargaining.
- d) In Canada during the 1970s the unemployment insurance provisions were liberalized in respect to duration, level and qualifying periods of benefits much more rapidly than in the United States. This created increased friction in the labour market and pushed Canadian wage rates higher.
- e) Over the decade from 1967 to 1976 the average federal Canadian minimum wage was increased by 180 per cent while the United States federal minimum wage was increased by 65 per cent (Table 6 on page 75). By mid-1977 the overall average Canadian minimum was 15 per cent higher than the U.S. federal level and much higher than in many contiguous U.S. states. Increased minimum wage rates put pressure on wages just above the minimum and eventually on all wage rates. (see pages 75 to 77 for a fuller discussion of minimum wages, particularly as they affect the tourist industry.)
- f) Canada's average of days lost due to strikes during the decade 1966 to 1975 was 38 per cent higher than that of the United States. In 1976 Canada lost 2.27 working days per worker whereas the United States lost only 1 day per worker.
- g) Contributing to this deterioration of labour relations in Canada was a variety of factors including:

* See Annex A for the detailed analysis.

- rapid inflation from 1973;
- the fringe benefits enjoyed by public sector employees which became objectives for the private sector unions;
- the perception of Canadian business by 1975 of the softened world markets and even stiffer import competition;
- the different pattern of collective bargaining in Canada as compared to the United States;
- the increased expectations which resulted from the buoyant state of the economy from 1972 to 1974.

The various factors cited above combined during the mid-1970s to push up Canadian wage rates. Since wages constitute a large component in the cost of production, this became an important reason why Canadian products were increasingly at a competitive disadvantage, especially during the years 1975 and 1976. By 1977, however, the situation improved. Increases in new wage settlements came down from 17 per cent in 1975 to 10 per cent in 1976 and to under 8 per cent in 1977. This last level was roughly parallel to the U.S. level. There was also a dramatic improvement in the strike record, with 70 per cent less man days lost than in 1976.

Provided the phasing out of the Anti-Inflation Board (AIB) in April 1978 does not result in a new wave of disproportionately high wage settlements and so long as the depreciated Canadian dollar remains at or below .90 cents U.S., Canadian industry will be in roughly the same competitive position it was in 1970.

b) Differences in Productivity

Undue emphasis on wage levels, however, should not obscure the fact that lower productivity levels in Canada are also a major contributor to the uncompetitive cost of many Canadian products. For manufacturing industries in Canada, labour productivity—the volume of output per manhour worked—is about 80 to 85 per cent of the U.S. level on average. Labour productivity is, however, an incomplete measure. There are other relevant factors of production which can be measured such as the amount or effective use of capital, the innovative capacity of the plant, the scale of the plant operations or the skill levels of managers. Together they constitute what is known as total factor productivity and affect the cost per unit of output. By this more complete measure Canada also has an approximately 20 per cent lower productivity level than the United States.

During the past decade the productivity gap between Canada and the United States has been narrowing slowly. A recent comparison by the Conference Board in Canada of goods' producing industries concluded that, between 1967 and 1974, output per manhour rose faster in Canada than in the United States. The gains in relative labour productivity performance were particularly strong in the Canadian durable goods industries, for example in the metal and wood products industries. It should be noted however that Canada is an efficient producer of some industrial products not susceptible of scale production, with rates of production comparable to

that attainable in the United States. Mr. Walter Ward, Chairman of Canadian General Electric, referring to "custom-built equipment" reported that

"Our transformer plant in Guelph, Ontario, produces approximately one-third as many units per year as its associate in Pittsfield, Massachusetts, and, as near as we can measure, the productivity at Guelph, in some years, is very close to that at Pittsfield." (I, 38:8)*

Further, it should be noted that not all Canadian industry suffers from comparatively low rates of productivity. In steel, cement, or pulp, Canada does well by international comparisons.

But these bright spots must not be allowed to obscure the fact that much of Canadian manufacturing is not competitive with that in the United States. Most of the large Canadian companies which testified before the Committee showed significant divergence in productivity levels with comparable U.S. operations, often within their own companies. (See Table 3). These were firms generally considered to be outstanding and successful in Canadian terms.

Table 3
Productivity Comparisons*

Product	Measure	Canada as % of U.S.	Company & Committee Proceedings
Business forms	tons per 100 man hours in 1976	64.2%	Moore Corporation (II, 15:8)
Petrochemicals	volume/man year	89%	DuPont of Canada (II, 11:23)
Fibres	volume/man year	88%	DuPont of Canada (II, 11:23)
Steel	ton shipped per man hour	99%	Stelco (II, 8A:27)
Portable Habitable Structures	board ft/min.	90%(Calg) 85%(Mtl)	ATCO (II, 2:14)
Major electrical appliances	output/employee	85%	CGE (I, 38:7)
Custom-built power transformers	output/employee	100%	CGE (I, 38:8)
Appliance motors	physical output/ employee	82.3%	CGE (I, 38:8)
Telecommunication equipment	output per individual	100%	Northern Telecom (II, 3:18)

*Most of the above figures are from companies with affiliated operations in the United States and Canada.

* Footnotes referring to Committee proceedings indicate the issue and page number. As evidence was taken during both the first and second sessions of the 30th Parliament, the proceedings of the first session (1974-76) are identified by the prefix I while those of the second session (1976-77) are identified by the prefix II; for example, (I, 18:24) or (II, 18:24)

In discussing Canadian labour productivity one fact must be stressed. The productivity gap is not caused by Canadian workers being less energetic and hard working. Witnesses emphasized that the Canadian labour force was just as diligent as that of the United States. Mr. David Culver of Alcan, for example, asserted that "Canadian workers in the aluminum industry are very good workers, as good as can be found anywhere in the world." (I, 35:11) and Mr. A.V. Peters of Michelin stated that the quality of labour at the Nova Scotia plant was "a pleasant surprise" and its labour productivity compared to the best in the parent plant at Clermont-Ferrand, France and to that in their U.S. plant as well. (II, 24:12, 30). Other factors account for the generally lower productivity in Canada. Of these, the most important are short production runs and the persistently low level of research and development done by industry in Canada. But there are others related to financing costs, management skills and taxation disadvantages. Finally there are certain natural higher cost factors inherent in Canadian production and transportation which are due to the severe climate and the ribbon-like shape of the Canadian market which geography has imposed.

c) Higher Unit Labour Costs

The problem posed by the rapid growth in Canadian wage rates in terms of competition with the United States was succinctly expressed by Mr. Walter Ward of Canadian General Electric

"The important fact is that Canada had, in effect reached and passed the parity point in manufacturing wages while it still was as much as 20 per cent away from reaching parity in productivity. In essence, the real problem that faces Canadian manufacturing today lies in this combination of factors." (II, 38:7)

The fact that the modest gains in Canadian productivity levels in the 1970s were far outstripped by increases in wage rates has meant a consistent increase in Canadian labour costs per unit of output relative to the United States. In the period 1970 to 1976, the cumulative increase in Canadian labour costs per unit of output amounted to 80.7 per cent as compared to 43.3 per cent in the United States.* With unit labour costs growing at such different rates in the two countries Canada's ability to compete in the U.S. market was significantly impaired.

Looking ahead, Canada is in a position to make productivity gains in the next several decades at a slightly faster rate than in the United States, if the right decisions are taken. The trend toward more liberalized trade will bring about some rationalization of the presently fragmented Canadian industry which should result in productivity gains. U.S. industry, which already has a relatively much higher degree of specialization, cannot expect to achieve the same level of improvements. But large production runs themselves are not usually sufficient to ensure that a product is competitive. A key ingredient to enhanced productivity is the development of new products, continuing and progressive improvement of existing products, as well as the

* Both percentages expressed in terms of U.S. dollars

implementation of new production processes and marketing techniques. The flow of innovative ideas in a firm depends largely on the research and development (R & D) being done. This report will discuss the problems and possibilities for effective rationalization and increased R & D in Canadian industry in Chapter IV.

Since the period during which the Committee heard its testimony, the depreciation of the Canadian dollar has largely compensated for the relative increase in unit labour costs in Canada relative to the United States, between 1970 and 1977. For the moment, with wage increases in the two countries roughly parallel and with strike activity in Canada at its lowest level since 1971, the competitive relationship which prevailed in 1970 has been largely restored.

Unfortunately, however, productivity increases at best will only support marginal adjustments year by year. Certain industries such as steel and auto assembly have productivity rates comparable to those in U.S. plants and these industries are the exceptions that can support real parity in wages. In general, Canadian productivity rates cannot support parity with the United States. If unit labour costs are to be competitive with U.S. industry, a substantial differential in the exchange rate of the dollar will be essential for many years. In the longer term, however, it would be preferable in industries with lower labour productivity than in the United States if increases in Canadian wage rates were restrained.

d) Comparative Taxation Levels

(i) *Corporate Taxation*

Taxes can have a major impact on industry's cost competitiveness.* The Committee received evidence documenting the tax disadvantage facing Canadian mining and forest industries compared to their American counterparts. However, Canadian corporate tax rates in general are a little lower than those in the United States. Combining federal and provincial levies, the rates vary between 46 and 51 per cent in Canada, whereas the comparable figure in the United States is about 50 per cent. For manufacturing and processing industries, the Canadian rates are substantially lower, running between 40 and 45 per cent. While Canadian treatment of losses is slightly less advantageous than that in the U.S., this is more than offset by the more favourable treatment accorded to intercorporate dividend payments.

In general, the United States provides stronger incentives to new investment through investment tax credit than does Canada. On the other hand, Canada permits very much faster write-offs for capital cost allowances than does the U.S. In Canada new manufacturing and processing equipment can be written off in two years, whereas in the U.S. many types of machinery have to be depreciated over ten to fifteen years for tax purposes.

Canadian producers, especially those who carry large inventories, are at a tax disadvantage relative to their American counterparts in periods of inflation, because inventory profits in Canada must be calculated on a "first-in-first out" (FIFO) basis

* This section summarizes a more detailed analysis made by the Committee which is attached as Annex B.

while U.S. producers have the option—which most have taken—of calculating these profits on a “last-in-first-out” (LIFO) basis for tax purposes. In April 1977 the Canadian government responded partially to this problem by introducing a 3 per cent inventory valuation credit.

In the United States, the Domestic International Sales Corporation (DISC) provides a considerably reduced tax rate for profits earned on exports. However, the preponderance of testimony by Canadian industry witnesses indicated that this U.S. export subsidy tax scheme had not been a major competitive disadvantage for Canada.

(ii) Resource Taxation

In the resource field, companies in the United States have a clear tax advantage. Companies in Canada must pay heavy additional fees, taxes and royalties which leaves them in a disadvantageous position vis-à-vis their U.S. counterparts. The Department of Finance calculates that while the effective rate of tax on income for all taxes is six percentage points lower in Canada than in the U.S. for all industries, it is 12 and 24 percentage points higher in Canada for the mining and forestry industries respectively.

A major problem for the Canadian resource industries, and particularly the mining industry in recent years, relates to the jurisdictional disputes between the federal and provincial levels of government over the right to tax. Witnesses testified that this combined tax burden was seriously constraining the development of new mines in Canada. Mr. Alfred Powis of Noranda said that Canadian taxes in this area were more than double those in parts of the United States. He gave illustrations from his company's mines in British Columbia, Ontario and Nevada. Fortunately, this situation has begun to improve. British Columbia and Ontario have both taken steps in 1977 and 1978 to lighten the tax burden on the mining industry in their provinces. In April 1978 the Minister of Finance indicated he was reviewing taxation of the mineral industry in consultation with the provincial authorities. Nevertheless, the uncertainties and complexities of double taxation continue to have a serious effect on economic health in the Canadian resource sector.

In the Committee's opinion, it is intolerable that two of the most important components of the Canadian industrial spectrum, mining and forestry, should be shackled in this fashion. **The Committee recommends to both levels of government that they reach agreements as soon as possible to reduce the tax burden on the non-fuel mining and forestry industries in the various provinces.**

(iii) Indirect Taxation

One of the more important differences in the structure of Canadian and American taxes on business relates to taxes other than corporate income taxes, particularly the much heavier indirect taxes which burden Canadian industry. Mr. R.D. Brown of Price Waterhouse & Co. explained that these hidden taxes—sales taxes on equipment and supplies, capital taxes, business and franchise taxes—were applied to Canadian business whether they were profitable or not. The general manufacturing sales tax of 12 per cent had no equivalent south of the border. Mr.

Brown called these taxes inefficient and characterized their impact as "a front-end load on Canadian industry" (I, 28:6). In fact, the burden of these taxes more than offsets the benefits of the lower Canadian corporate tax rate described above.

The April 1978 budget appeared to recognize the burden by its offer to finance provincial retail sales tax reductions by 2 to 3 per cent, but this measure is only temporarily in effect and designed to provide an economic stimulus. A more permanent solution is important to improve Canadian competitiveness. Several possibilities have been suggested. The complete exemption from the federal manufacturing sales tax and from provincial sales taxes of a broad range of producers' goods would certainly alleviate, though not eliminate this problem. This method would cause a minimum amount of administrative problems under existing tax structures, but could involve a significant revenue loss. A second method would be to rebate to producers the sales tax which has been levied on inputs which they purchase. While this solution is administratively more difficult than the first, it would probably provide the maximum of benefit to producers with a minimum of loss of revenue. The suggestion of several witnesses that the sales tax burden could be eliminated by switching to a value added tax (VAT), similar to that used by European countries, to assist manufacturers does not appear to be readily applicable to Canada. The main difficulty would be that the sales tax field is shared between federal and provincial jurisdictions. However, since proposals recently advanced by the Minister of Finance for the replacement of the federal manufacturing sales tax with a wholesale tax are to be re-examined, the Committee recommends that the above proposals, or other methods designed to reduce this "front-end load" tax burden on producers, be given urgent consideration.

(iv) Personal Income Taxes and Social Security Tax Levels

The Committee heard testimony from numerous Canadian business witnesses relating how difficult it is for their companies to bring young executives to Canada because of the comparatively much harsher tax régime. In fact, the average Canadian personal income tax burden is not much higher than the U.S. and there is a wide variation in tax levels across states and provinces which makes comparison difficult. Nevertheless, as of 1977, an employee earning roughly \$20,000 or over faced higher taxes in Canada than in almost all states in the U.S. and if this taxpayer were married and the sole earner in the family, he was quite severely disadvantaged relative to a U.S. counterpart. The typical young executive earning about \$30,000 would fall into this category. The tax differential could increase if the executive moved from a low tax state to a high tax province. While a move from the high tax state of New York to the low tax province of Alberta would result in a saving of almost \$1,000 in income and social security taxes, a move from a low tax state such as Texas to a high tax province such as Saskatchewan could result in additional taxes of about \$4,000. Quebec would be even more disadvantageous. The "brain drain" from Canada to the United States is naturally influenced by this situation.

However, average tax rates do not tell the whole story, and transfer payments may go a long way to offset higher personal income tax burdens in Canada. Payments received via family allowances and hospital and medical insurance have no

U.S. counterpart. Moreover, the combined old age security/Canada Pension Plan benefits in Canada are likely to be higher upon retirement than U.S. social security payments. Most of these benefits would, however, be of little or no interest to a U.S. executive working only a few years in Canada and are not of prime consideration to many productive and entrepreneurially-minded Canadians.

(v) Taxation and Uncertainties in the Investment Climate

One other factor of Canadian taxation which bothered Canadian industry related to the business uncertainty created by the almost continuous revisions in the tax system. Not only does business find it expensive to cope with the administrative difficulties caused by the rapidity of tax changes, but more importantly, it loses its basis for making long term investment decisions.

Whether this situation is much worse than pertains in the United States is difficult for the Committee to judge. However, it is important that governments, both federal and provincial, recognize the handicap effect on Canadian business of constant unpredictability in corporate taxation fields.

e) Exchange Rate

The decline in Canadian competitiveness in the U.S. market in the mid-1970s was attributed by a number of witnesses to the over-valued Canadian dollar which reached as high as \$1.03 in terms of the U.S. dollar by mid-1976. Both resource and manufactured goods exports were hampered by this situation while the import of manufactures was stimulated.

Since the time the testimony was received, the value of the Canadian dollar has declined to a level that falls within the .85 cent to .95 cent (U.S.) range which most witnesses in late 1976 considered as more "appropriate", considering the existing differences in costs and productivity in the two countries. Canadian unit labour costs had risen 52 per cent since 1970 compared to 35 per cent over the same period in the U.S.

In 1977 the Canadian dollar declined during most of the year, falling below .90 cents in terms of the U.S. dollar by late October. An examination of trade figures for the fourth quarter of 1977 reveals the important impact which a realistically valued dollar can have on trade patterns. For this period the volume of imports was down by 1.8 per cent from the corresponding quarter a year earlier whereas exports were up 12.2 per cent. Imports of end products declined by 2.5 per cent in volume terms from a year earlier and exports in this category increased by 15.7 per cent. Inflation, however, meant that the dollar deficit in end products was not reduced, while for the same reason improvements in exports of resource commodities were reflected in the larger dollar surplus in this category.

Analysts are inclined to attribute this welcome trend in fourth quarter figures to the dollar's devaluation in 1977. It is however, difficult to be sure how much is due to the pick-up of the U.S. economy, which has shown greater strength than the Canadian economy. In any case, as Mr. Carl Beigie, Executive Director of the C.D.

Howe Research Institute, told the Committee at a time when the dollar was woefully overvalued yet sustained by heavy external borrowing

"the exchange rate as a tool for adjusting to what has happened to wage and productivity trends between the two countries is a very blunt instrument." (I, 29:11)

Blunt it may be, but the devaluation of the Canadian dollar has provided the essential corrective element to compensate for competitive weakness. Unfortunately, while providing essential relief, it does nothing to correct the underlying structural problems which bedevil Canadian production.

f) Relative Financing Costs

A focus of concern for many industries was the financing of capital formation. By far the most important source of new financing for the private sector is within companies themselves. This source has been growing increasingly inadequate—both because of depressed profit levels and the inflated costs of new plant and equipment. From 1971 to 1973, 75 per cent of funds for financing new or replacement investment were generated from internal company sources whereas for the years 1974 to 1976, only 66 per cent of funds were so generated. Business representatives before the Committee compared the situation in Canada unfavourably with the situation in the United States and blamed a lack of governmental and public understanding of the role of profits in business.

In addition, it was observed that lower interest rates in the United States make capital borrowings easier for firms seeking to expand or improve. Nor has there been the same availability of capital for borrowing in Canada as is generally the case in the United States, the Committee was told.

In the mid-1970s the differential between Canadian and U.S. interest rates widened substantially. The premia of rates from 1972 to 1976 on Canadian industrial bonds over U.S. corporate bond rates averaged about 130 basis points. While the difference narrowed somewhat in 1977 it is expected that Canada's heavy capital requirements during the next few years will keep the Canadian rate higher for some time to come.

g) Higher Machinery and Equipment Costs

Another area of higher capital costs in Canada relative to the United States was the higher cost for equipment and machinery. Canada imports a very high proportion of industrial equipment; in 1976 over \$2½ billion from the United States alone. Evidence was presented to the Committee showing that Canadian forestry producers paid an average of 15.5 per cent more for machinery and equipment than their U.S. counterparts. Averaging all sectors, a 1976 study estimated prices for machinery and equipment could be 25 per cent higher in Canada than in the United States. U.S. producers can easily surmount the tariff and still compete with Canadian producers. While lower import tariffs might help reduce slightly the costs of machinery and equipment, this is a cost which Canadian industry will have to continue to absorb.

h) The Natural Disadvantages of Climate and Geography

Some costs can be attributed to the climate and geography of Canada and represent an inescapable cost handicap which Canadian business must bear in competing with U.S. business in Canada, in the United States, or abroad.

The colder climate has meant higher costs for Canadian industry. Insulation, deep foundations and other cold weather building specifications add costs to the construction of plants and warehouses. Heating costs are higher, as is construction in the winter. The Canadian climate is also an inhibiting factor for forest growth, a cost factor becoming particularly evident to the forest industry in competition with companies harvesting the much faster growing trees of the south-eastern United States.

Climate and geography combine to make access to resources more difficult and costly than in the United States. Resource companies in remote areas are frequently required even to set up town-sites and provide municipal services.

Because of the geographic stretch of Canada, Canadian manufacturing companies are often faced with high transportation costs in order to get their goods to market. The sparse population of 23 million, stretching in a narrow ribbon across a continent over 5,000 miles wide, represents a badly structured market on which to build a domestic market base. U.S. plants can usually reach the necessary concentration of markets much more readily. Business witnesses also observed that, because of the distances and transportation costs involved, they were obliged to carry between 50 to 60 per cent more inventory than in a comparable U.S. plant.

2. Causes of Relocation and Disinvestment

As referred to in the previous chapter, there has been a significant movement by many Canadian companies to set up plants in the United States or to expand their U.S. operations rather than those in Canada. Simultaneously U.S. companies are cutting back on reinvestment in Canada and are repatriating profits. For the first time in 1977, U.S. parent companies took more funds out of Canada than they invested in Canada, including reinvestment.

Industry witnesses gave a variety of reasons behind each decision. Businessmen explained that they sought the lower wage rates and the higher productivity rates in the United States. They mentioned:

- the lower capital costs in the United States for plant and equipment;
- the greater availability and lower costs of financing;
- the more favourable tax rates and lower transportation costs;
- the availability of the export incentive scheme DISC;
- the ready availability of highly developed cores of research and development (R & D);
- a better availability of trained managerial personnel;
- a more favourable industrial relations climate in the U.S. with labour unions less politically involved; and

- the availability of non-unionized labour in some southern U.S. states.

During 1975 and 1976 the high exchange rate of the Canadian dollar was seen as a stimulus to relocate in the United States.

In discussing the investment drain and trends to relocate in the United States, many witnesses spoke critically of the unfavourable business environment in Canada as compared to that south of the border. Canadian businessmen referred repeatedly to the widespread misunderstanding in Canada of the importance of profits. For example, both Mr. Ian Barclay of B.C. Forest Products and Mr. Walter Ward of Canadian General Electric stressed that profits must have a realistic relationship to adequate return on equity investment. Furthermore, profits were needed to maintain or expand plants and to replace inventory, which in periods of inflation meant at inflated figures. Mr. R. W. Chorlton of Wajax was more blunt.

"We have permitted the development of a concept whereby profit has become a dirty word, and profitable corporations are believed in some mysterious way to siphon off the wealth of society for their own nefarious ends. Nothing could be further from the truth. Profits generated by Canadian corporations are the life blood of our economy." (II, 9:22)

Dissatisfaction and uneasiness were expressed over the degree of government intervention in the Canadian market place. This was coupled with examples of the difficulties posed for industry by unpredictable government policies. Industrial undertakings requiring long term financial lead times were being restricted, witnesses said, by uncertainties of government policy. Mr. W. A. Darby, General Accountant, Taxation, of Stelco spoke of the difficulties which companies could encounter in this regard.

"Any incentives that are adopted should be put in place for a long-term period. You cannot put your foot on the capital spending accelerator and then put on the brake. You must have time for advance planning. You cannot react quickly. It has to become an integral part of the Canadian tax structure so that when we make our long-range plans, we have a reasonable idea of what our return on investment is going to be." (II, 8:58)

Mr. Carl Beigie of the C.D. Howe Research Institute drew the distinction between "the fundamental difference in apparent philosophy" between the United States and Canadian governments. The Canadian approach, he said, has been "to increase regulation, to increase the use of marketing boards, to increase government intervention, to increase controls on exports." (I, 29:13) Businessmen and labour representatives reiterated this theme to the Committee, both groups frequently referring to the AIB's controls as an example. There was, however, a recognition that controls had conferred certain benefits as well and may have been necessary.

A number of business witnesses complained about the unproductive industrial relations atmosphere in Canada as compared to the United States, citing the fact that the labour unions in Canada were more political and less business-oriented than their U.S. counterparts.

The crisis of confidence in the Canadian business environment appeared to afflict U.S. investors and businessmen as well as Canadian. Mr. William Eberle, the former U.S. Trade Negotiator to the Tokyo Round of the multilateral trade negotiations and now a businessman, explained to the Committee the perceptions and concerns current in the United States.

"We in the United States are, first and foremost, worried... about the attitude toward investment in Canada and this is brought out first of all by your FIRA, wage and price controls, by the rate of inflation. It is a concern that is hard to put one's finger on, but the question which pervades most board rooms in the United States is whether this is the kind of country in which to place investment. There is concern as to whether or not long term profits are going to be there; there is concern as to the future of the private enterprise system in Canada." (II, 17:11)

Recognition by the U.S. business community and economic analysts that the principal objectives of the Foreign Investment Review Act (FIRA) are not to block investment, as much as to gain better terms for Canada, has been slow in coming. However, the U.S. Administration has stated that it does not consider FIRA to be a "serious obstacle" to most foreign direct investment in Canada.*

While Canada has long been regarded in the United States as a reliable trading partner, a number of developments in the 1970s may have caused a reassessment of this attitude and may be responsible in part for the disinvestment trends by U.S. companies. Such decisions as the 1973 phase-out of Canadian oil exports for example was a surprise blow to U.S. industry. Even though there is now a wider U.S. understanding of the reasons for the change, the initial reaction to the "blue-eyed Arabs of the North" included outraged demands for retaliation. Mr. Eberle characterized this as "the Canadian shock to the United States." (II, 17:29)

The nationalization by the Saskatchewan government of a part of the potash industry produced a strong negative reaction from the United States. The United States is heavily dependent upon Saskatchewan as a source of potash. Almost 70 per cent of U.S. potash needs came from Canada in 1974. In an aide-mémoire on the issue to the Canadian federal government, the United States government spoke of "the major potential for damage to U.S. interests and to U.S.-Canadian relations inherent in this action."** A number of U.S. political figures expressed concern over the security of their import supply. Even though the Saskatchewan government made it clear it wished to expand production (and presumably sales), some of the U.S. customers tended to interpret Saskatchewan's action as an attempt to increase revenues by restricting supplies and increasing prices. In the opinion of Mr. Alfred Powis, President of Noranda, the Saskatchewan government's policy has resulted in U.S. attempts to develop alternative sources of supply of potash in third countries such as the Soviet Union. However, the 1977 decision of U.S. producers to develop potash deposits in New Brunswick suggests that U.S. attitudes may be relaxing.

The recently announced intention of the Quebec government to take over a U.S.-owned asbestos company in Quebec has produced a similar uneasy reaction in the United States, although it may have been less unexpected. The 1976 election platform of the Parti Québécois had called for nationalization of this industry, which accounts for 80 per cent of Canadian production and 50 per cent of the free world supply. Since the election, the policy emphasis of the Quebec government has been to seek to increase the amount of processing of this product within the province.

* U.S. Embassy, Annual Review of the Canadian Economy 1977

** Aide-mémoire, U.S. Embassy, Ottawa, December 9, 1975

There is no doubt that the election of the Parti Quebecois government in Quebec has had an unsettling impact on the U.S. business and investment community's perception of Canada. The concept of Canada as a cohesive and unified country has suffered a serious blow in Americans' minds. Doubts as to the reliability of Canada as a resource supplier have been sown by this Quebec political development as well as by provincial expropriations of U.S. resource companies. Certainly there is enough concern in Washington as to the extent of provincial powers over resources that some press reports have suggested that the United States seek to develop direct relations with the provinces rather than dealing through Ottawa.

An important and somewhat surprising stimulus to the expansion and relocation of Canadian companies in the United States, as well as to the reduced investment by U.S. subsidiaries in Canada, is the prospect of reduced tariffs resulting from the current GATT trade talks. It was argued that, for Canadian companies, any tariff liberalization on top of the other competitive disadvantages of producing in Canada, would make it more attractive to produce in the United States. Mr. R. W. Chorlton of Wajax commented,

"Now because of the rapid escalation of Canadian wage rates we are studying . . . our manufacturing at our Seattle plant. Preliminary indications are that because of lower component costs, lower wage rates and a somewhat larger domestic market, we would derive corporate economic benefit from closing down in Canada and developing our Seattle unit. Any reduction in Canadian tariff rates would, of course, increase these benefits." (II, 9:21)

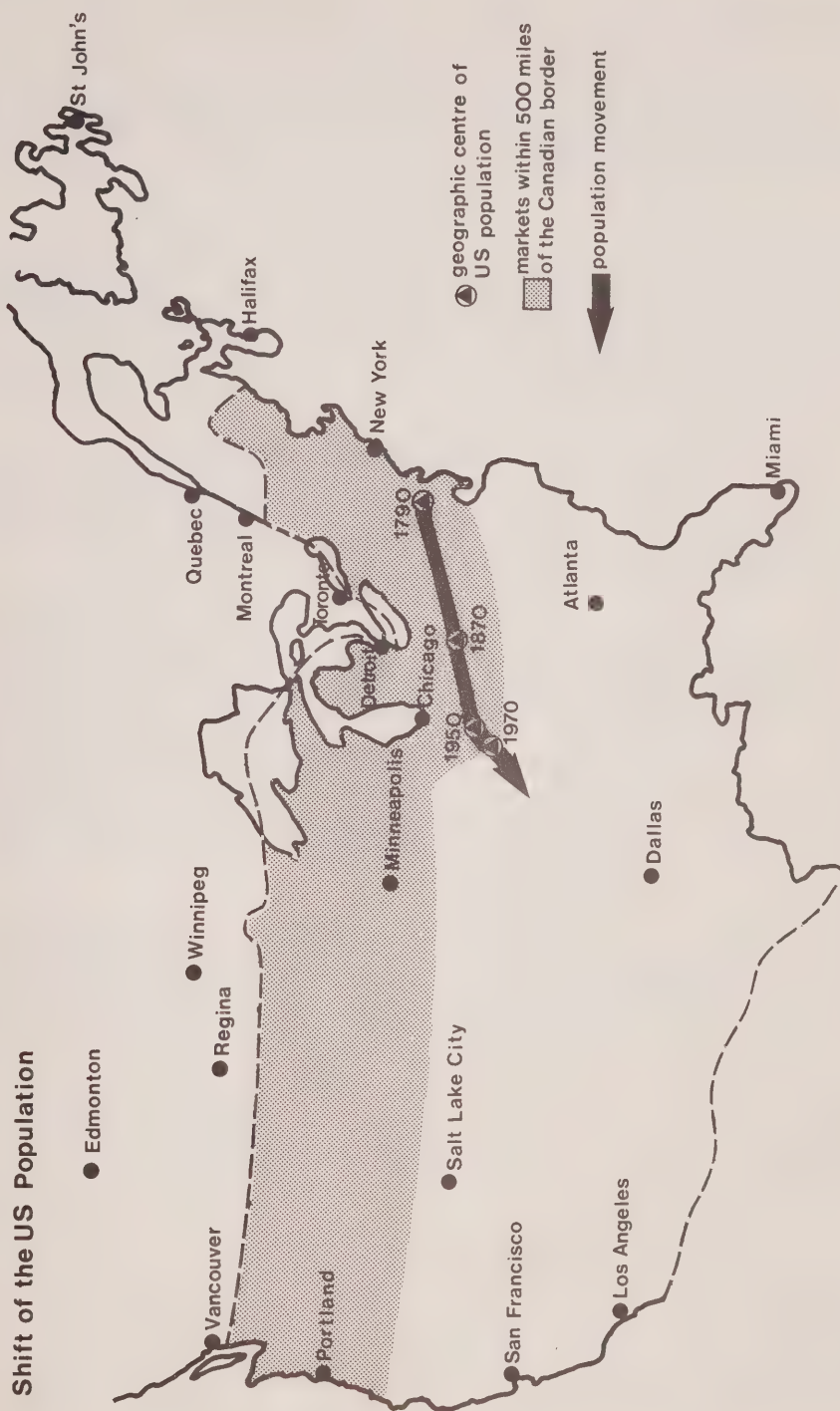
U.S. multinationals, influenced concurrently by the more fundamental change taking place in the location of standard technology industries on a global scale, also appear to be considering the reduction of production facilities in Canada. According to a 1978 survey by the U.S. Department of Commerce which forecasts planned capital expenditure by U.S.-controlled companies in Canada, such expenditures will rise by only 1 per cent as compared to 5 per cent in 1977 and 10 per cent in 1976.

The attitude toward tariff liberalization by both Canadian companies and U.S. subsidiaries in Canada appears to be almost entirely defensive. Preoccupied with their vulnerability if the Canadian tariff were lowered, producers in Canada expressed little if any interest in the expanded opportunity of exporting to the U.S. market when U.S. tariffs were simultaneously lowered. Part of the explanation, at least for Canadian-controlled companies, may lie in the presumption that non-tariff barriers such as import quotas and U.S. procurement practices represent obstacles to exports from Canada which would nullify the effect of a reduction in the U.S. tariff. (As far as U.S. subsidiaries are concerned, many are constrained by the parent corporation from selling in the United States in any case, so their indifference to the U.S. market opportunities is not unexpected.) A number of witnesses whose firms were expanding into the United States were quite explicit that U.S. federal and state procurement policies constituted barriers to market penetration which could only be effectively circumvented by establishing U.S. production centres. Some witnesses spoke of the difficulties posed by the U.S. customs administration, while others feared the imposition of U.S. import quotas. In short, a whole range of non-tariff measures were seen to loom large in restricting market penetration in the United States.

The implications of such a situation for the future of Canadian manufacturing can only be regarded with concern. Even if a Canadian producer, wishing to export to the U.S., succeeds in reducing his costs and produces a product competitive with a U.S. product in the U.S. market, he could be restricted in that market by non-tariff measures. This at least appears to be the view of the Canadian exporting companies which are minimizing their risks by locating production facilities within the U.S. itself, thereby protecting the access of their products to 90 per cent of the total North American market.

Finally, another factor in the relocation and expansion in the U.S. is the steady and continuing shift of the U.S. population from the east and north towards the south and west of the United States; that is, farther and farther away from the production centres of the Canadian manufacturing industry. This problem was raised by the Canadian Manufacturers' Association and in the Committee's opinion is a valid point which does not appear to be sufficiently recognized. The accompanying map illustrates the movement of population during the past two hundred years in the United States, a movement which actually understates the shift of industry and of purchasing power. The population of the south and west is younger and tends to have higher patterns of consumption. The economic life of the area is more vigorous than the national average. Industry is newer and concentrated in fields which tend to be growing faster. In 1975, approximately 80 per cent of total Canadian sales of fabricated and end products to the United States were made to states lying within approximately 500 miles of the Canadian border. As purchasing power and industry moves toward the south-west, selling to the U.S. market and serving it from Canada will become increasingly difficult and costly. It is little wonder that many Canadian companies anxious to profit from this large and fast-growing market throughout the south and west of the United States, have established or expanded production and service facilities across the border.

Shift of the US Population



IV TRADE STRENGTHS AND PROBLEMS FROM A SECTORAL VIEWPOINT

1. Resource Sector

Canada is the United States' most important single source of industrial raw materials. In 1976 Canada provided 23 per cent of U.S. imports of industrial raw materials in the non-fuel category and 14 per cent of fuel imports. In the same year, 34 per cent of U.S. imports of seven non-ferrous metals came from Canada and 64 per cent of its iron ore imports.

In both crude materials and resource-based fabricated products, Canada has a large trade surplus. In 1977 for example, Canada exported \$5.4 billion worth of crude materials to the United States and imported \$1.7 billion for a surplus of \$3.6 billion. In fabricated materials, it exported in the same year \$10.9 billion worth of goods and imported \$4.9 billion for a surplus of almost \$6 billion.

An assumption has been prevalent in Canada in recent years that Canada is "a hewer of wood and a drawer of water" for its industrialized trading partners, notably the United States. Stimulated perhaps by the large foreign—mainly U.S.—ownership in the Canadian resource sector, the idea had gained wide acceptance that Canada's non-renewable resources are being exploited with little benefit to the country. In contrast to this popular assumption, the Committee received ample evidence demonstrating the large degree of upgrading of many resource-based products which is already taking place, and the significant amount of "value added" in early stages of resource processing.

There is in fact a general public misunderstanding about the extent of actual processing of Canadian resources already taking place before export. Apart from the natural gas and petroleum industry, where 95 per cent of the product is used as fuel for energy purposes in a relatively unprocessed form, there is in fact little justification for the popularly-held "hewer and drawer" image. Part of the problem appears to stem from failure to recognize that "value added" is not synonymous with the final assembly of end products or finished manufactured goods. In the processing industries, "value added" can, nevertheless involve considerably more employment, skill and technology than are involved in the manufacture of many end products.

The forest products industry accounts for approximately 12 per cent of the "value added" of all primary and manufacturing industries in the country. In British Columbia, the forest industry provides direct and indirect employment for 250,000 people. Mr. Ian Barclay of B.C. Forest Products Limited pointed out that certain wood products which might seem to be only slightly processed such as bleached chemical pulp actually contained more "value added" than kraft linerboard and some rough grades of paper. Mr. John Stenason of Canadian Pacific Investments

(CPI) estimated that kraft pulp represents at least 80 per cent of the processing from basic wood fibre to finished paper product. Newsprint, a major Canadian export to the United States, is in the most finished state possible for export since American newspapers can hardly be written, edited or printed in Canada. A cut and dressed piece of 2" x 4" lumber represents considerably more "value added" in terms of capital and labour than many finished manufactured goods and is, except for the final assembly in a house, in its most processed state.

For the mining industry, there are many examples of significant "value added" in the primary stages of processing. Table 4 prepared by the Noranda group of companies, illustrates the distribution of "value added", capital requirements and employment generated as copper is mined, concentrated, smelted, refined, made into rod and transformed into building wire. 60 per cent of the "value added" occurs

Table 4
**Capital Required, Direct Employment Created and Value Added
at Different Levels of an Integrated Copper Industry**

	Mining & Conc.	Smelt. & Refining	Rod Mill	Wire & Cable	Total
Capital Required (Mill. \$)					
Fixed Assets	\$300	\$250	\$15	\$190	\$755
Working Capital	<u>20</u>	<u>30</u>	<u>15</u>	<u>110</u>	<u>175</u>
Total	<u>\$320</u>	<u>\$280</u>	<u>\$30</u>	<u>\$300</u>	<u>\$930</u>
Employees Required	1,200	450	50	2,500	4,200
Value Added					
Per Pound Copper	\$0.75	\$0.25	\$0.02	\$0.69	\$1.71
Per Year (Mill. \$)	\$150	\$50	\$4	\$138	\$342
Per Employee					
Fixed Capital	\$250,000	\$556,000	\$300,000	\$76,000	\$180,000
Working Capital	<u>17,000</u>	<u>67,000</u>	<u>300,000</u>	<u>44,000</u>	<u>42,000</u>
Total Capital	<u>\$267,000</u>	<u>\$623,000</u>	<u>\$600,000</u>	<u>\$120,000</u>	<u>\$222,000</u>
Value added per year	\$125,000	\$111,000	\$80,000	\$56,000	\$81,000
Through Rod					
% of capital required	51%	44%	5%	—	100%
% of employees	71	26	3	—	100
% of value added	74	24	2	—	100
Through Wire & Cable					
% of capital required	35%	30%	3%	32%	100%
% of employees	29	11	1	59	100
% of value added	44	15	1	40	100

Note: The above assumes development of two typical British Columbia open pit mines each producing 50,000 tons of copper in concentrate per year, integrated with a smelter plus refinery capable of producing 100,000 tons of metal per year. All of the metal would then be rolled into rod which would then all be drawn into building wire. Capital costs are estimated in unescalated 1976 dollars and a copper price of \$1.00 per pound is assumed.

Source: Estimates by Noranda Group companies.

before the rod is drawn into wire. Similarly, Mr. Stenason of CPI pointed out that over 60 per cent of the processing of lead and zinc is achieved at the concentrate stage. He told the Committee that, for lead and zinc, 80 per cent of his company's production was fully processed or significantly processed in Canada, while all of its production of forest products, including pulp and paper, was Canadian processed, either wholly or largely. Mr. Alfred Powis of Noranda gave the Committee some overall Canadian figures which showed that in 1974, 80 per cent of Canadian copper exports to the United States had been transformed to the metal stage, 59 per cent of zinc exports and 53 per cent of lead.*

Aluminum undergoes extensive upgrading. Sometimes mistakenly thought of as a Canadian resource, it is a product made from mainly imported raw products. To these raw materials, Canadian aluminum producers apply capital, labour and energy in a labour-intensive upgrading process. Mr. David Culver of the Aluminum Company of Canada gave the Committee an example of the contrasting amounts of "value added" at two stages, the more intensive amount being in the earlier stage.

"If we then take the pound of aluminum ingot and roll it into a pound of sheet, the popular concept is that we have added a lot of value and provided a lot of jobs. Well, we have just built a new, very modern rolling mill in Kingston, Ontario, which can roll 150,000 tons of aluminum sheet per year. It provides 165 jobs. But back in the Saguenay, there are going to be 2,250 men working in the chemical plants and smelters to produce that 150,000 tons of ingot for the rolling mill in Kingston." (I, 35:12)

This works out to be approximately 15 times the number of jobs in the creation of a ton of aluminum than to roll it into aluminum sheet, a later stage of processing.

Another major processing industry, the Canadian steel industry, has developed into a modern, efficient and competitive force on the basis of indigenous iron ore and imported coal. While not a major export industry, it now supplies 90 per cent of the Canadian domestic market, reinforcing the fact that in such industries, import substitution is as important as exporting. Some fabricated iron and steel products have made significant inroads into the U.S. market in recent years. While large volumes of iron ore are shipped to the United States in raw or pelletized form, U.S. iron ore and coking coal are also shipped into Canada to provide, most economically, the raw materials basic for some companies' steel manufacturing. This bilateral exchange of iron ore is mainly a matter of transportation economics.

In the petroleum and natural gas sector, Canada is now embarking on upgrading through a number of world-scale petrochemical plants of which the two largest are ethylene plants, one in Sarnia, Ontario and the other in Red Deer, Alberta, each with a capacity well in excess of 1 billion pounds a year. According to the Canadian Chemical Producers Association, the total "value added" for the oil and gas used by the petrochemical industry for feed-stock in Canadian manufacturing, although only 5 per cent in volume, is equal to the "value added" for the whole of the oil and gas used as fuel.

Nor can the Canadian resource sector be considered merely as an unsophisticated extractor and processor from a technological point of view. Contrary to popular

* Although he made the point that the lead and zinc figures suffered from the distorting effects of a strike.

belief, the amount of high technology and skill levels is often superior to that employed in the mass production processes of secondary manufacturing. Moreover, these processes have frequently had important export spin-off benefits. As Mr. Tom Burns of Industry, Trade and Commerce said

“Even the so-called crude materials are generally the end result of sophisticated production methods. Agriculture, mining and forestry, which are important primary industries in Canada, have achieved their high degree of efficiency largely because of very substantial investments of capital, a wide use of science and technology and a skilled and experienced labour force . . . For example, because of the nature of our mineral resources, Canada has been very successful in developing geophysical instrumentation, advanced techniques of topographical mapping, as well as automated cartographical techniques, all of which have entered into our export trade.” (I, 22:8)

The resource sector makes an important contribution to regional development and employment, often in remote areas. Mr. Culver pointed out that Alcan had approximately 20,000 people working in Canada, “in areas where alternative employment was not plentiful.” He estimated that over 10,000 Canadian jobs depend upon the U.S. aluminum market alone (I, 35:6). The Canadian forest industries support nearly one million jobs directly or indirectly. They are of major importance to rural Canada; many communities have no other industry.

These positive contributions of the resource industry to the achievement of a balanced national development have not been fully recognized in recent years by the federal and many provincial governments. Not only does it contribute in a major way to the Canadian balance of payments, but there is a very significant degree of “value added” involved in resource processing and there are important high technology and regional benefits derived from this sector. The question is how much additional upgrading and processing of Canadian resource-based exports to the United States can be realistically expected?

a) U.S. Tariff Protection on Fabricated Products

The U.S. tariff presents problems to Canadian resource processors exporting to the United States. Like the Canadian tariff and that of other industrialized trading partners, the U.S. tariff generally rises with the degree of processing of the imported goods. It is only fair to point out, however, that access to U.S. markets for such products is considerably easier than to either Japan or the European Community.

Since the United States is itself a major producer of most natural resource products it is not surprising that it seeks some protection for its own processing industries. It is the world's largest producer of mining products and a substantial net exporter of some of them. This is the case for many copper products, for molybdenum and for zinc alloys except for those products related to the automotive industry. Mr. Alfred Powis of Noranda explained the U.S. tariff impact on Noranda's operation.

“We cannot get into the U.S. market from Canada in those copper products because of the tariff structure. Therefore if we really want to operate in the U.S. market, we have to locate our plants there”. (I, 36:12)

Mr. John Stenason of Canadian Pacific Investments Limited said that the stiff U.S. tariff against very high purity metals used in electronic manufacturing is the reason why their subsidiary, Cominco, set up a processing plant in Spokane, Washington, and shipped Canadian raw materials there for processing.

Officials gave the Committee an example of tariff impact based on 1971 figures. Canada exported \$285 million worth of unwrought nickel to the United States with no duty but semi-manufactured nickel attracted a nominal duty of 8.8 per cent and imports of these products dropped to \$2.6 million over an average weighted tariff of 2½ per cent*. Canadian exports of unwrought copper facing a weighted average tariff of 1.7 per cent were \$133 million. Semi-manufactured copper goods faced an average weighted tariff of 3.1 per cent and exports amounted to \$41 million.

The impact of the escalating U.S. tariff can also be seen in exports of the forest products industry. While raw lumber trades freely, a U.S. tariff is imposed as soon as the board is stained or sanded and it escalates at a rate which depends on whether it is made into veneer or plywood, prepared for flooring, doors or containers or processed in other ways. The average U.S. tariff for wood-based panels is 16 per cent but it reaches as high as 20 per cent for Douglas fir plywood. Some tariffs appear illogical. A U.S. tariff of 2.5 per cent on a dowel for example, jumps to 16.66 per cent if the dowel has a hole in its end. Pulp, paper waste, paper and paperboard face no tariff or very low U.S. tariffs, and Canada's exports in these items totalled \$1½ billion in 1971. But pulp and paper manufactured exports are subject to tariffs around 7 per cent and Canada exported only \$11 million of these products. While many of the U.S. tariffs against resource based goods are numerically low, i.e., below 5 per cent, they can be effective in blocking Canadian exports.

The effective rate of protection afforded to the U.S. processors' "value added" by these tariffs is often two or three times as great as the nominal rates would seem to imply. This is especially so when the nominal tariff protecting the processed product is higher than the tariff on inputs. For example, if the tariff on fine papers entering the United States is 6.2 per cent and the tariff on the principal input, pulp, is 0 per cent, the rate of protection of the "value added" in the fine papers will be greater than 6.2 per cent; how much greater will depend on the relative importance of pulp cost to the total cost of producing fine paper.

Conscious of these barriers against resource-based processed goods, Canada has attempted to focus attention on resource-based tariffs in the current GATT negotiations. Mr. Tom Burns of the Department of Industry, Trade and Commerce explained that the government's objective was to press for better access

"... so that there is an opportunity for Canadian producers to look at a market that is larger than the Canadian market for these downstream products, and thereby remove one of the important inhibitions against establishing in Canada the scales of production which would make us competitive internationally in downstream products." (I. 22:25)

* An average weighted tariff is a level reflecting the tariff average of items within a category, weighted by the volume imports entering the United States.

Canada's tactic to attain its objective has been to promote sectoral negotiations, that is to put the products of an entire industry on the negotiating table from the crude to the processed stage of production. By this approach, Canada hoped to reduce all tariffs or non-tariff measures now in place against a particular product at all the various stages of processing or manufacture. Canada specifically proposed negotiations in non-ferrous metals and forest products and government negotiators have used copper as a model for supporting their proposals. The United States gave cautious support to the sectoral approach and even proposed sectoral negotiation in steel, but by early 1978 other important GATT participants were responding negatively to this approach and it appears to have lost its chance of being used as a framework for negotiating tariffs.

The GATT negotiators had, by early 1978, agreed to make cuts along the lines suggested by Switzerland. The Swiss formula calls for a 40 per cent average cut with high tariffs being cut more deeply than low tariffs. This immediately presents Canada with a problem vis-à-vis the United States and its other major trading partners, because an estimated 90 per cent of Canada's dutiable exports to these partners encounter tariffs which are low but nonetheless effective in frustrating Canadian efforts to further process many raw materials before export. Such tariffs will receive comparatively smaller cuts. On the other hand, Canadian tariffs on manufactured goods, of which it already imports more than the three main industrial partners combined, are relatively higher than similar tariffs of other industrialized countries. These tariffs on manufactured goods will receive more drastic reductions leaving Canada more vulnerable to imports.

With the resource industries very much in mind, Canada has taken the position of linking its willingness to make tariff cuts along the lines of the Swiss formula to the progress which the negotiations make in two other areas, namely

"to the degree of success in eliminating, reducing and bringing under control certain non-tariff measures and on the willingness of the other participants to meet Canada's objective of a greater liberalization of tariff and non-tariff barriers in the key resource-based sectors of Canada's export trade (non-ferrous metals and forest products)".

This linkage will presumably permit Canada to argue that if it does not receive commensurate cuts on a weighted average for its resource-based exports it would be able to make lower-than-formula cuts on its own higher-than-average tariffs or obtain an increased number of exemptions from those lists. The outcome of the GATT negotiations is therefore, vitally important to increased Canadian processing for export.

A more liberal access to the U.S. market for resource-based products is desirable. **In the Committee's opinion therefore the reduction or elimination of these escalating tariff barriers must be a prime Canadian objective at the GATT negotiations.**

However, tariffs in the United States and elsewhere are not the only constraint to increased processing. Even if Canada achieved all its objectives at Geneva with respect to better tariff access for resource-based products, it is not at all clear how much more resource processing and upgrading in Canada would result. Canadian businessmen cited other constraints.

One most frequently cited was market proximity. Mr. David Culver said Alcan had not only aluminum sheet mills in the United States but specialized mills for the building products trade and a whole series of service centres, mobile home centres and small staging points. These were located near the local manufacturer so that Alcan could supply him with his more specialized requirements. The company also had several American plants which manufactured electrical bare and covered wire and cable from imported Canadian-made aluminum rod or wire bars. Mr. Culver doubted that a significant change would result in this pattern of production, even if the U.S. tariff were eliminated.

"I would hate to see us deceive ourselves into feeling that if we paid a very high price in some way in order to achieve, let's say, total free trade in the products we are talking about, both ways, that things are suddenly going to change, or even that over time there would be a tremendous change in the location of manufacturing facilities. The reason I say that is that basically the further down the line one goes, the more it is a local service business". (I, 35:18)

Mr. Powis of Noranda confirmed that the higher the level of processing, the closer to the market the production facility needed to be. He commented on the reasons why his company's very large aluminum products plant in Cleveland was not built in Canada. It was even a mistake to have built in Cleveland, he said.

"We should have a number of smaller plants closer to the market. The products tend to be tailor-made for the particular market you are operating in. You need fast delivery, otherwise your inventories get out of hand. In a great many cases our warehouses are just too far away from that Cleveland plant and we are now considering the possibility of breaking it up into a number of smaller units". (I, 36:23)

For the lead and zinc exports, Mr. Stenason of Canadian Pacific Investments emphasized that they must be closely geared to the needs of the existing market. He also made the point that if Canada did not want to supply concentrates to use in existing foreign smelters or refineries, he was confident there were other foreign competitors who would be happy to do so.

In the forest products industry, Mr. Stenason pointed out that the manufacture of fine paper was also market oriented. However, the advantages of proximity to market do not prevent competitive inroads from more distant producers. As Canada's cost competitiveness has decreased, when strikes and higher Canadian costs hit the Canadian industry in 1975 and 1976, fine paper imports from the United States took a greater share of the Canadian market despite a sizeable Canadian tariff and the acknowledged benefit of local production facilities.

The close market-orientation of another type of paper production was most striking. Moore Corporation is a Canadian-owned firm controlling 28 per cent of the U.S. business-form market, as well as 40 per cent of the Canadian. Mr. David Barr, Chairman of the company, testified that because fast service was competitively important, the company had located its manufacturing units strategically throughout the United States and Canada, each serving a limited geographic region. For sales to large companies such as Ford, Sears Roebuck and General Motors, Moore Corporation even has its own personnel working on the customers' premises on a full-time basis. For this reason, Mr. Barr thought that it was unlikely that reduction of the high tariff (20 per cent) imposed by both countries on business forms would affect the present locations of their manufacturing plants. The need to be close to a

regional market was, however, reinforced by two important non-tariff barriers—government purchasing and country-of-origin labelling.

Another constraint, at least at present, is the relatively high capital cost disadvantages of newly constructed Canadian facilities. Mr. John Stenason warned that any new Canadian smelting or refining plants built at current high costs and designed to penetrate export markets, including the U.S. market, would have a very difficult time competing with the products of existing low-cost plants in those countries.

In respect to the increased processing of Quebec asbestos a 1978 industry report pointed out that the market for traditional asbestos products was being rapidly overtaken by new asbestos based products or by non-asbestos substitutes. Rather than expanding processing in Quebec, the challenge to the industry will be to develop new products and processes in order to maintain and expand its market.

In addition, non-tariff measures such as quotas can be instrumental in barring exports of resources and resource products to the United States. Mr. Alfred Powis told the Committee that Canadian zinc and lead exporters fight a continual battle against the attempts of American industry to have quotas on imports. In December 1977 an application by U.S. zinc producers sought an increase of the tariff from 0.7 cents a pound to 7 cents a pound for imports in excess of a base quota. In January 1978, the U.S. government was being petitioned by copper producers to increase the tariffs or impose quotas on refined copper. Even if U.S. tariffs were lowered on fabricated materials as a result of an agreement in GATT, significant increases in exports might be blocked by a variety of constraints, unless special access to the U.S. market was gained through a free trade agreement.

The goal of better U.S. access for upgraded products, is particularly important at this time for the Canadian petrochemical industry. The two new petrochemical plants scheduled to come into operation by 1980 will produce such products as ethylene, propylene and polyvinyl chloride. They will have enormous excess capacity. Only about half of the ethylene can be absorbed into plastic production on the domestic market through import substitution. The remainder must be exported to make the plants viable. The United States has already voiced an interest in improving access for these products provided additional Canadian gas supplies were made available. However, the Arab countries are also interested in upgrading their petroleum resources and the same *quid pro quo* vis-à-vis the United States will be available to them in this respect. The U.S. petrochemical industry itself will be seeking more not less protection and the competition from the established lower-cost Gulf coast producers will be very difficult for the Canadian industry which has construction costs of up to 20 per cent higher. The prospects for Canada are not particularly bright unless Canada entered a special arrangement with the United States.

A number of problems are facing many of Canada's resource industries. In the mining sector, world demand is unstable. Under-developed countries rich in resources have been undermining commodity prices by sustaining production regardless of cost and demand in order to maintain employment and earn foreign currency. Inventories are high, prices are generally low. Several Canadian ore bodies are of low

grade and have been brought into production through mining expertise and high capital investment, whereas many new ore bodies in third world countries are more competitive than Canadian bodies. Challenges of another sort in the form of seabed nodules face domestic producers of metals.

The forest industry, particularly in Eastern Canada, is suffering serious difficulties due to new competition from the fast-growing trees of the southern United States. These well-planned, carefully managed, planted forests are easily accessible and readily harvested by efficient mechanical means. They are not constrained by the more rigorous climatic conditions or the rough terrain of Quebec, New Brunswick and British Columbia. Technological advances have reduced the competitive advantage of Canadian softwoods for pulp by devising new methods of pulp and paper production from hardwoods.

Despite its present and future problems, the Canadian resource sector remains the backbone of the economy and of its export trade. Without its foreign earnings, not least in the United States, Mr. Carl Beigie of the C.D. Howe Institute considered that

“even though we want to be less dependent on resource industries, what has been happening in the wage field suggests to me that in order to pay for our needs in external markets, we are going to have to be probably at least as dependent on resources for as far into the future as I can see”. (I, 29:17)

It is essential for Canada to retain a vigorous and healthy export sector. For reasons discussed in another section of this report, the Committee doubts that Canadian secondary manufacturing can, in the foreseeable future, become a strong export performer, except in a few selected indigenous high technology areas. However, in many fields of resource development, Canada is known as a world leader. In mining, sophisticated technological equipment and techniques have been developed in Canada. In most cases there is no problem of Canada running out of resources. Except in the fossil fuel sector, Canada's resources are renewable or in adequate supply for generations to come. Despite certain built-in Canadian disadvantages resulting from climate and the remote location of many of the raw materials, Canada continues to have important assets, a skilled labour force, long years of experience and some sources of inexpensive energy. Rather, Canada's difficulties derive from a recent sharp increase in unit costs of production, which the depreciation of the Canadian dollar has done something to reverse, and a variety of barriers limiting access to foreign markets.

In regard to improved competitiveness the Committee has already indicated its concern over the onerous impact of double taxation in the resource field and recommended that governments at both levels eliminate this burden as quickly as possible.* Here as elsewhere there has been far too little recognition of the capital required for investment and expansion purposes, and until recently, little understanding of the need for after-tax profits for expansion. On the resource industry's part, with few exceptions, there has been little governmental recognition of the need to increase their R & D so as to improve their technological capacity and develop new processes which will also improve their competitiveness.

* see above, Resource Taxation p. 22

Mr. David Culver had a wise word to say about competitiveness and value added in Canada's resource sector. he stressed the importance of adding value *efficiently*. Otherwise, he said, it would be better to concentrate on developing efficiently the resources Canada had been blessed with.

"Rather than talking about seeking value added, I think we should start by saying that we seek value efficiently added and make sure we go after the conditions which will permit the efficiency. Then I am sure we are getting a net gain. Otherwise, we run this risk of frittering away some of our advantages by striving to add value when we cannot add value as well as somebody else can." (I, 35:16)

In addition, **efforts must be made by both industry and government to increase public understanding of the value of the resource sector to the national economy.** A commendable and responsible beginning to this campaign has been initiated by the pulp and paper industry, and this may stimulate comparable efforts in other resource industries.

b) Two Areas for Examination

In its discussion of the Canadian resource and manufacturing industries, the Committee identified two areas for which important basic data were not available. Before intelligent economic decisions can be made, the relevant facts, figures and costs must be publicly and clearly at hand. The Committee concluded that there were requirements for:

- a) a study to determine the relative costs and contribution to the economy made by the resource-based industry as compared to secondary manufacturing
- b) a review of Canadian statistical classifications.

(i) *The Relative Costs and "Value-added" Contributions of the Resource and Secondary Manufacturing Sectors*

In the face of rising energy costs, increasing capital costs, and hard-to-measure environmental and social costs, Canadians are asking what are the relative benefits of increased emphasis on resource upgrading as compared to a more rapid development of import-competing and export-oriented secondary industries. As long as there is competition for scarce energy or financing, the encouragement of one sector usually means the discouraging of another. The federal government has, under the Export-Import Act, broad discretionary powers to use export controls in order to promote further processing. Should such controls be used and, if so, under what conditions? Before pursuing such policies, it is essential to have all the facts.

The Committee recommends a major study which would analyse and compare the effect on Canadians and the Canadian economy of the relative "value-added" contribution made by resource-based industry as compared to secondary manufacturing. Such a study should be undertaken by one of Canada's leading research institutions. The inquiry might explore: the amount and nature of employment to be generated in each sector including skill levels, pay levels, the comparative regional and urban-rural incidence of activity, whether directly or indirectly generated; the comparative net tax effects; the relative technological sophistication of both sectors' activities; the relative dependency on foreign capital, equipment, technology and

management, and the relative impact on the renewable and non-renewable resource base.

(ii) *Problems in Statistical Classifications*

There appears to be a shortcoming, even a distortion, in the statistical data available in respect to Canadian manufactured goods. It is understood that the data are classified according to international breakdowns, but do these classifications suit the Canadian economy? The artificial separation of "fabricated" or "processed" goods such as lumber or newsprint from the rest of the "manufactured" products or "end products" distorts the amount of manufacturing done in Canada and the actual imbalance of trade in manufactured goods. This report has indicated that many products such as newsprint or lumber are already taken to their final points of manufacture before being exported. There has been an unfortunate and misleading tendency to equate the end products category of manufactured goods with "high technology" and the fabricated group with "low technology". However, witnesses emphasized that there is more high technology involved in producing pulp and paper than in building a television set. The unfortunate result has been that the huge imbalance in end product trade has been generally misinterpreted as showing Canada has little high technology manufacturing.

Officials from Industry, Trade and Commerce before the Committee acknowledged that both fabricated materials and end products were manufactured goods and stated a preference for classifying them together. They pointed out that in the United States' commodities statistics, various items which under the Canadian system would be segregated were grouped together under the heading of manufactured goods.

The Committee recommends that Statistics Canada examine this problem of classification.

2. The Manufacturing Sector

The Canadian Manufacturers Association told the Committee that Canada has a deficit in manufactured products with every country with which it trades and in every major commodity grouping. Canada also takes a higher proportion of its imports in manufactured form than other major countries—74 per cent as compared to 60 per cent for the United States and 32 per cent for the European Community. This situation is reflected in employment figures. And the situation is deteriorating. Mr. Walter Ward of Canadian General Electric reported that the proportion of the Canadian workforce engaged in manufacturing declined from 24 per cent in 1960 to 22.5 per cent in 1973, a decline not paralleled in other industrial trading countries during the same period.

According to figures produced by the Science Council, Canada has fallen behind other industrialized countries in its rate of industrialization. Whereas in 1955 Canada was second only to the United States in terms of the production of manufactured goods per capita, by 1974 it had been overtaken by six other industrialized countries; Sweden, France, Japan, Finland, Australia, and West

Germany. Others including Norway, Belgium, Denmark, Austria and Italy have come from far behind and almost overtaken Canada. In terms of the value of finished manufactured goods as a per cent of total exports, Canada's earlier place near the lead has been retained only because of the tremendous spurt of exports achieved as a result of the Automotive Agreement of 1965. If trade arising from the Automotive Agreement is excluded however, Canada made scant progress in its finished manufactured exports—an increase in two decades of only 3 per cent compared to Denmark's 11.3 per cent, France's 5.5 per cent, Mexico's 16.8 per cent and Sweden's 10.8 per cent. Mr. John Shepherd, Executive Director of the Science Council said that Canada could almost be considered to be "de-industrializing as a country", and a recent Science Council report referred to the sixties as "a period of serious decay in Canadian manufacturing".* This unsettling conclusion is more disturbing when it is recalled that the "golden" sixties are generally assumed to have been a very successful period of Canadian industrialization. It is now apparent that the Auto Pact-induced exports concealed an otherwise generally weak performance.

The United States is Canada's main market for manufactured goods and Canada is the largest market for U.S. manufacturers. In 1975, 70 per cent of Canada's imports from the United States were classed as end products, although the portion falls to 38 per cent if automotive products imports are excluded. 39 per cent of Canadian exports to the United States are end products, but this declines to 11 per cent if exports of automotive products are excluded. While the last figure is relatively low, the United States is, nevertheless, by far the best market for Canadian manufactured goods. Moreover, as has been noted previously, there is much more manufacturing in the exports of fabricated materials from Canada to the United States than is generally realized and than is reflected in the statistical classification.

Canadian exports in dollar terms have been growing in all categories, reflecting in part the recent high rates of inflation. However, as chart 4 demonstrates, in 1977 Canada's export of end products (other than automotive products) actually declined, even though the U.S. economy was performing well. The erosion of the U.S. market for Canadian manufactures has occurred at a time when U.S. goods have been increasing their penetration of the Canadian market. In the important machinery industry sector, for example, a recent government study found that between 1970 and 1975 the percentage of the Canadian market supplied by domestic production fell from 46.9 per cent to 37.7 per cent. Excluding automotive trade, the bilateral imbalance in end products with the United States has grown sharply: from \$4.4 billion in 1975, to \$7.7 billion in both 1976 and 1977. The trends are unmistakably unfavourable and require a fundamental reassessment of the role of manufacturing in Canada.

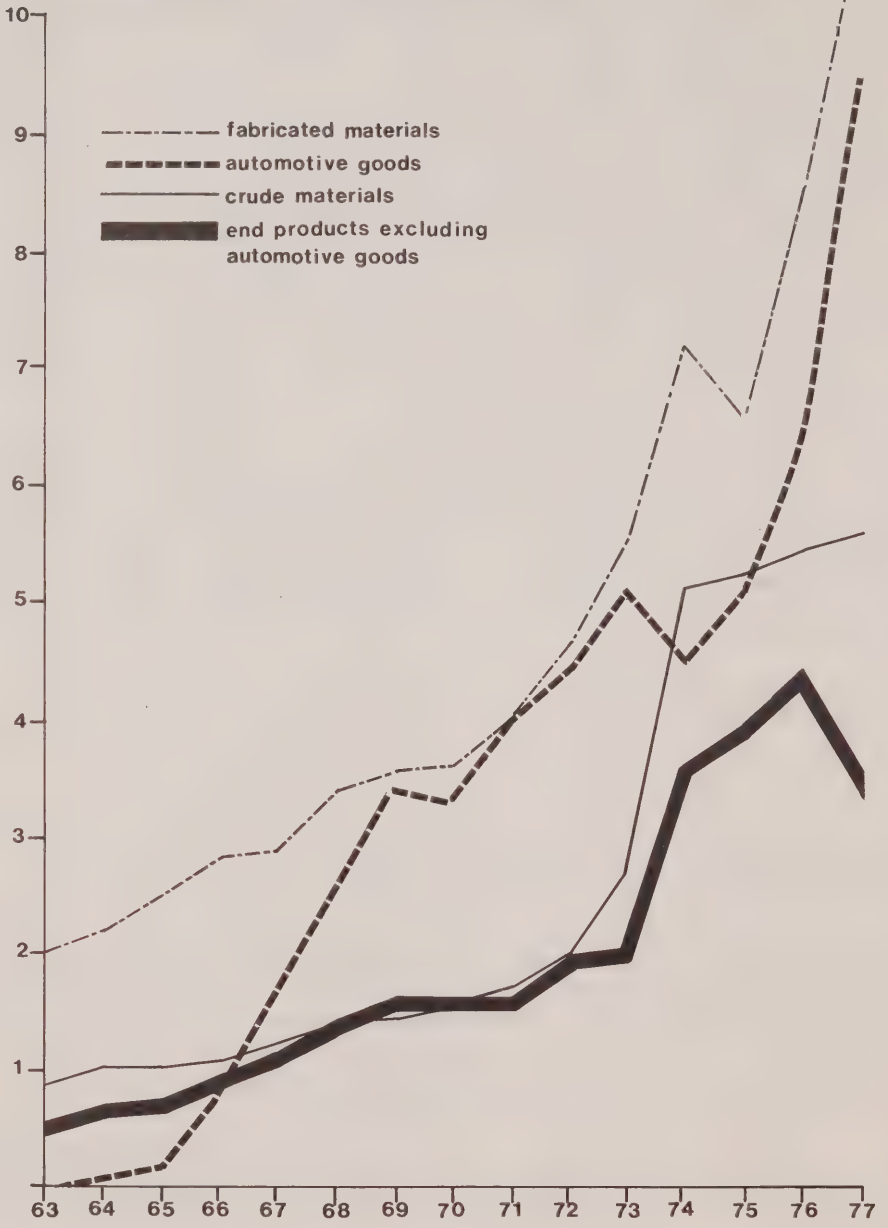
a) Structural Problems in the Manufacturing Sector

A phenomenon of the post-war world has been the development of highly efficient large-scale units of production with a considerable emphasis on product specialization. The trend has been assisted by increasingly efficient, low-cost trans-

* *Uncertain Prospects*, Canadian Manufacturing Industry, 1971-1977, p. 3

Chart 4

Canadian Exports to United States 1963-77, (\$billion)



Source: Statistics Canada

portation although this will now be constrained as fuel costs rise. Both these developments favour countries with large domestic market bases.

Canada is severely disadvantaged by the size and shape of its domestic market—a mere ribbon of 23 million people strung out the width of the continent. It has with Australia the dubious distinction of being one of two industrialized countries without free access to a market of at least 100 million persons. However, because of geographical proximity to the United States, Canadian tastes and expectations, to a far greater degree than those of Australia, have been influenced by the U.S. market. While called upon to produce the same wide range of product choices, Canadian industry has been unable to achieve the economies of scale necessary for efficient production of many items at competitive costs. Sophisticated automated production equipment cannot keep unit costs down if the machines must be stopped and readjusted frequently for product differentiations such as colour, size and pattern.

For several decades, Canadian tariff protection has allowed its small scale and high cost manufacturing to remain relatively unchallenged. Mr. Carl Beigie commented,

"I do not know of any other country as small, in terms of its domestic market, as Canada that has such pretensions about being able to duplicate the industrial structure of the much larger economies. We produce virtually everything in this country and we do not seem to be able to decide whether we want to specialize on the one hand, or protect, on the other." (I, 29:21)

Tariff protection combined with lack of access to a large market has meant that those Canadian manufacturers producing mainly for the domestic market have remained relatively unchallenged with their small scale high cost operations. In the mid-1970s, however, the deterioration in the competitiveness of Canadian manufactured products combined with post-war tariff reductions reduced the effectiveness of the tariff wall to the point where many U.S. imports penetrated the Canadian market easily. Canada is not only exporting less manufactured end products, but it is buying much more from the United States so that the bilateral deficit in this category is now reaching an enormous \$8 billion annually. Small plants devoted to the domestic market are in difficulty even with the existing tariff and are totally unprepared for the sizeable tariff reductions which may be agreed to at the Geneva GATT trade talks.

The weaknesses resulting from small scale production and lack of specialization have been compounded by the high degree of foreign ownership of the Canadian manufacturing sector. Inadvertently and somewhat paradoxically, the tariff, originally designed to protect Canadian industry from U.S. incursions, has been instrumental in the growth and establishment of branch plants in Canada. Eager to sell their products in Canada and to benefit from the British Preferential Tariff, U.S. businessmen established subsidiary plants behind the Canadian tariff wall. Geographical proximity made it especially easy for them to do so. The result is that more than 50 per cent of Canadian manufacturing, including many key industries, is foreign, mainly U.S. controlled.

It is in the secondary manufacturing sector, as distinct from the resource sector, that foreign ownership has resulted in the fragmenting of the Canadian industrial

structure. The establishment of "miniature replicas" of the parent corporations has been the usual pattern; subsidiary companies designed to produce a similar range of products as the parent but often for the small Canadian market only. There are some exceptions where subsidiaries have been set up as part of a total North American production pattern and allocated specialized producer lines to produce for larger specified markets. These have unfortunately tended to be the exception rather than the rule.

Many branch plants operate under some constraints in exporting. A survey done by the Department of Industry, Trade and Commerce of 800 American manufacturing subsidiaries in Canada found that 58 per cent operated under some form of export restriction and of these 33 per cent were excluded from the U.S. market.* However, aggregate figures show that foreign-controlled firms in Canada do about as well as Canadian-controlled firms in exporting, particularly if the automotive industry is included. One is left to speculate what might have been their export performance if more of the firms had been rationalized on a North American basis or if they had not been constrained by market allocations.

In respect to imports, existing statistics reveal that foreign-owned firms are more import-oriented than Canadian firms and that an increasingly large proportion of total Canadian imports are in the form of inter-affiliate transactions. It is not surprising that American subsidiaries would import significant quantities of machinery and components from affiliates or their established sources. Cost, availability and familiarity combined with specialized technical factors probably influence such choices. Yet rigid or familiar patterns of inter-affiliate procurement can make it almost impossible for a Canadian producer seeking to enter the market. And this is so even if his product is competitively priced. Professor Ray Vernon of Harvard University told the Committee that because multinationals usually had a global strategy, they were more impervious to price competition. According to several witnesses, this has had a frustrating effect on the development of indigenous Canadian firms.

The necessary domestic rationalization of the Canadian manufacturing sector through mergers or joint ventures may be inhibited because so many firms are subsidiaries. The fear of extra-territorial application of U.S. anti-trust laws on their Canadian plants may cause U.S. parent corporations to be wary of allowing structural amalgamations of their subsidiaries although this may be perfectly legal or even encouraged in Canada. In discussing the negative effect of foreign ownership on Canadian managerial capacities and development, several witnesses expressed concern that Canadian management personnel working in subsidiary firms are likely to be limited in their decision-making responsibilities and may not be developing the skills for innovation and risk-taking. Mr. R. W. Chorlton of Wajax commented that capital management and market strategy expertise is frequently situated outside of Canada, that executive direction of the "Canadian satellites" is integrated with the U.S. parent management pool and that the subsidiaries in Canada have

"... skeleton management groups led by a young aggressive manager on his way to the 'big job' south of the border, or by an older man who is close to retirement." (II, 9:20)

* *Foreign Direct Investment in Canada*: Industry, Trade & Commerce, 1972, p. 163

Testimony indicated that foreign ownership was also a factor in restricting the amount of R & D done in the Canadian manufacturing sector. A number of witnesses emphasized the low R & D expenditures by foreign-owned firms in Canada have tended to impede Canadian innovation and the development of distinctive marketable export products.

b) New Challenges

A recent challenge to the domestically-oriented Canadian manufacturing industry is the growth of new low-cost manufacturing centres in developing areas such as Taiwan, Korea, Brazil and Hong Kong, the "new Japans" as they are called. Low cost standard technology items are being efficiently manufactured by very low-wage workers in these countries at costs which can absorb the Canadian tariff and compete easily on North American markets. Dr. André Raynauld, Chairman of the Economic Council of Canada explained to the Committee that while the import challenge was already serious from the United States, Japan and the European Community, it would become much more severe from these low cost countries. The unmistakable trends are for a continued and intensified erosion of the domestic market by these standard-technology import products. Multinationals will find it in their interest to produce standard technology items in low-wage cost countries instead of in Canada. Mr. John Shepherd summarized the problem when he stated that "Canada is being whipsawed between low technology countries with low labour [costs], and advanced high technology countries with a better competitive edge in design and development". (II, 18:9)

As has already been mentioned, an even greater challenge, potentially, will face Canadian producers if the GATT multilateral trade negotiations succeed in lowering tariffs on manufactured goods by 30 to 40 per cent. The challenge here will be to meet the cheaper imports on the Canadian market with competitively priced products and at the same time to take advantage of the easier access to the U.S. market to increase Canadian exports. It was evident from the testimony that few Canadian manufacturers felt they were prepared for the intensified competition.

c) Areas of Specialization

Canadian industry is being outpriced in its attempts to produce a wide range of low or standard technology items for its small market. While it is not difficult to reach the conclusion that Canada should no longer try to participate in many of these areas, it is more difficult to pin-point which areas of secondary manufacturing Canada might specialize in. Most prescriptions advocate finding particular areas of high technology in which Canada could have an advantage. According to Mr. John Shepherd of the Science Council, studies in the United States have shown that technologically intensive industries grew 45 per cent faster, their employment 88 per cent faster and their productivity 38 per cent faster than low-technology based industries.

The Economic Council considers that Canada's "comparative advantage" will lie in "knowledge-intensive" activities by which Dr. André Raynauld meant undertakings requiring a fairly sophisticated level of training and skill in the labour force.

"Because our labour costs in particular are bound to be far higher than those in low wage countries, we must focus on areas of production where our more highly trained workers can help to achieve results not available in less developed economies". (I, 18:6)

In many cases, the "knowledge-intensive" activity to be exported would involve the output of intangibles rather than goods and he gave as an example a research project which Canada would conduct for a particular project in an advanced country with the subsequent production of the item being carried out in a low-wage country.

While this emphasis is for the long term and with world export markets in mind, witnesses drew attention to other possible areas of specialization which related more closely to indigenous elements in the Canadian scene springing from geography, distance, climate, or natural resources. There are still other areas where restructuring, rationalizing and perhaps concerted public procurement policies could ensure a solid domestic base, reduce the level of imports and possibly lead to some exporting.

Mr. Shepherd pointed out that there was an "industrial vacuum" in the field of renewable energies—such as solar energy, wind energy and biomass—which could be seized upon to build competitive Canadian corporations. In addition, cold ocean engineering, the defence of Canada's maritime limits and its Arctic sovereignty, the transport of resources from the North, mining machinery, electronics and project management systems, communications and transportation requirements were suggested as areas of specialization by this witness. Professor Abraham Rotstein of the University of Toronto emphasized the need "to dovetail our manufacturing capacity to a greater utilization of our resource base" and suggested the petrochemical field and other products related to Canadian resources for which Canada is at present a net importer as well as communications technology and marine technology. (II, 20:8,9)

The link between specialization and Canada's natural resources and indigenous elements was repeated in the testimony of manufacturers themselves. Mr. Walter Ward of Canadian General Electric pointed out that even with the necessary improvements in the factors affecting Canada's competitive position and a sound domestic market base, no single Canadian plant in the appliance industry could match the production costs of a single U.S. plant at present. He gave an excellent example, however, of how a Canadian company can specialize in areas where there is no disadvantage from small scale production.

"... the things we can export and the things we can really do a job on tend to fall into categories where Canada has some indigenous advantage... Canada is a country of vast distances, with one of the highest uses of electricity per capita in the world, with large power blocks, such as the big provincial utilities. (Ontario and Quebec Hydro are amongst the biggest in the world.) This provides, in effect, an outdoor laboratory for the development of certain kinds of equipment such as DC transmission equipment for electrical transmission of large blocks of power... We are active in the international market in this area, such as in large air blast circuit breakers for large transmission systems; and similarly with hydro power generation... We have sold these very large generators for the Grand Coulee project in the United States. We have recently sold power circuit breakers to TVA, a large public utility in the United States..."

The second thrust we have is also a strength of a multinational subsidiary. We have some areas of technological excellence in Canada. For example, a couple of years ago we came to an agreement with General Electric that we would take responsibility for the development and supply of large air blast circuit breakers. This is because we had developed the technology in Canada; and we have big systems in Canada, in effect, a natural laboratory in the country.

General Electric is selling this product on our behalf in the United States, and we are selling it overseas where we can.

We have a joint arrangement on high voltage DC equipment, where we are doing the same thing. Likewise, we have an advantage in hydro-electric generators, where we have had a long history of very competitive technology . . . where we have moved into joint venture arrangements with some General Electric affiliates in other countries. For instance, in Brazil, where General Electric has manufacturing plants, we work with them to produce the sufficient local content to satisfy the requirements of the Brazilian government. We in Canada provide other components along with the necessary technology. We maintain our presence that way in markets that otherwise would be closed to us because of what are in effect non-tariff barriers." (I, 38:13)

This CGE example combines a number of important ingredients for successful specialization in Canada:

- products with a specialized market rather than a mass consumer market
- a joint venture or joint arrangement with an affiliated company
- the utilization of existing marketing facilities of the multinational company
- the relationship to indigenous Canadian conditions such as the geography requiring long distance transmission lines and the availability of hydro-electric power

Machinery for the natural resources industries was the area for specialization emphasized by Mr. R. W. Chorlton, a machinery manufacturer. Canada already has a capability in some forest and mining machinery products. There appear to be favourable circumstances at the moment particularly in Western Canada and the Arctic which will require advanced and sophisticated machinery and techniques both for operational and transportation needs.

Although the overall picture remains somewhat bleak, there are isolated and impressive success stories where Canadian firms have improved their competitive position, enlarged their share of the domestic market and increased their exports. Unfortunately, there is no simple prescription for success. But the achievements of some Canadian companies must be regarded as proof that there is no fundamental reason why Canadian manufacturing industry cannot succeed in international competitive terms in specialized high technology areas.

d) Possible Policy Responses to the Problem

Until now, the response of Canadian federal and provincial governments to the deteriorating situation in the secondary manufacturing sector has been to rely increasingly on intervention in the form of subsidies, import quotas, regional developments grants, marketing boards, etc., in effect, protectionist devices. But as Mr. Carl Beigie pointed out, there have been heavy costs to such government intervention in terms of efficiency and production which inevitably lead to increased demands for more support and intervention. The alternative to government intervention, he said, is to rely on market forces which can be a far more efficient allocative system for growth and expansion than the decisions of government can ever be. In the face of the present difficulties, Mr. Beigie summed up the situation as follows:

"I see the question of allowing international market forces to have a bigger role in determining the evolution of the Canadian economy as the only real option to an increasing proliferation of interventionist policies by government in response to demands of the Canadian people". (I, 29:19)

Mr. Beigie has raised a major question: whether Canadian industry should have more government support programs or be exposed to increased international competition through the lowering or eliminating of tariff barriers? Mr. Beigie's preference is clear: external competition is needed to force Canadian industry to rationalize and specialize. But another witness, Mr. John Shepherd of the Science Council asserted that tariff reduction, at this time, "effectively ensures disaster by introducing the patient to a cure he cannot survive". (II, 18:11). He favoured instead a series of government programs designed to encourage the rationalization of industry, to promote R & D efforts through offering increased incentives, and to stimulate promising products through coordinated government procurement policies. These and other techniques to strengthen Canadian industry were discussed and reviewed by the Committee with its various witnesses. They are examined with an assessment of the benefits which might be derived from each one.

(i) *The Possibilities for Rationalization*

There was no lack of acknowledgement by industry witnesses of the weaknesses and problems of secondary manufacturing in Canada. Witness after witness explained the higher costs of making a large variety of products in small scale Canadian plants and even more of short production runs compared to the efficiencies of the American large scale plants and long production runs. Mr. Ian Barclay, Chairman of British Columbia Forest Products Limited said that in plywood production there were

"... any one of five firms in the United States who can themselves produce about half the Canadian market requirement and with large economy of scale you can certainly bring your costs down." (II, 6:26)

Mr. Franklin McCarthy, President of Du Pont explained that

"For the large majority of Du Pont of Canada products, particularly in man-made fibers and plastic resins, plant scale is perhaps the single most important determinant of efficient low-cost and hence international competitiveness." (II, 11:47)

Nor did Canadian producers consider that the idea of consortia of firms for the purpose of *export only* as permitted under existing competition policy had improved the situation. Mr. Ian Rush, President of Polysar stated

"We must have the base-load of a domestic market before we can think of exporting ... The domestic producer must be competitive. When there are numbers of firms each with plants, none of these plants are competitive. Even if they were to get together for export purposes, it would not have a significant effect in helping their cost position." (II, 11:40,41)

Export consortia have been little used, partly because they do not, by themselves, reduce costs and partly because of the difficulties of defining the rights of the parties to enter or withdraw from such agreements and the detailed arrangements for coverage, duration, and shares.

Industry representatives reiterated the prior importance of a healthy base in the domestic market as a spring board for exporting. Northern Telecom, for instance, told the Committee that its strong position in the Canadian electronic equipment market made it possible for it to compete successfully in the highly competitive U.S. electronic market.

The fragmented structure of Canadian production is a difficult situation to rectify. While no one disputes the need for domestic rationalization of manufacturing in Canada in order to achieve more efficient, low cost production, there was no consensus on how to do this nor indeed whether it could be done. The most effective approach, if it were possible, would be to leave the process to the action of natural market forces. Du Pont has, by its own volition, reduced the number of lines of nylon products made in Canada by more than half since 1969. But such an approach in an industry where economies of scale await realization will only lead to lower costs if the domestic market is large enough to absorb the increased production or if an export market can be developed. In fact, as costs of production relative to the United States have increased in recent years in Canada, the tendency has been for some Canadian production to be displaced by imports so that the market for domestic production actually contracted in some fields. In the overall, the evidence suggests that natural forces cannot be counted on to produce domestic rationalization in Canadian secondary manufacturing sufficient to achieve in the short term increased productivity and lower unit costs. Some other methods are needed.

One device which has been suggested is duty remissions to encourage rationalization. Some years ago Du Pont offered to cut down the number of nylon products it made in Canada and increase the volume of production of the remaining lines if it could obtain import licences to bring complimentary lines in tariff-free from its U.S. parent company.* While this proposal was rejected, several comparable remission suggestions have in recent years been approved by the government. The Committee reviews the potential of this approach below** and recommends its wider application in the machinery field. Nevertheless, it must be acknowledged that this approach is not capable of general application and that, depending on relative levels of tariffs, it may even have a distorting effect on trade. It can bring short term benefits and promote some rationalization, but it cannot resolve the problem in the long term.

Instead of total structural mergers of two or more companies, Professor Lawrence Skeoch promoted rationalization through joint ventures, partial or quasi-mergers, specialization agreements and joint marketing arrangements. He told the Committee that these approaches were more flexible than total mergers which he described as

“... an omelet which you cannot unscramble because you have destroyed the organization, and it seems to me that the internal organization... is just as important to a firm as the possession of patents perhaps.” (II, 16:16)

The incidence of these partial mergers has increased much more rapidly in Europe and the United States in recent years than total mergers. With this technique, he suggested Canadian firms could produce a product with some firm in the United States or elsewhere in the same way European automobile manufacturers have combined to produce the V-6 engine. These techniques could facilitate the borrowing of the most advanced technology and such arrangements with U.S. firms could also help ensure access to U.S. markets. Professor Skeoch commented that the quasi-merger is “a technique of getting some of the advantages of economies of scale

* Caroline Pestieau: *The Canadian Textile Policy: A Sectoral Trade Adjustment Strategy*, p. 70

** See p. 64

and of getting into export markets without just having to make a head-on assault on those markets". This partial form of rationalization has apparently been used very little by Canadian industry up until now. The hesitation of industry may be explained by industry's fear of being judged in restraint of trade under the existing legislation (although such arrangements are theoretically possible).

On the basis of its brief look* at competition policy from the point of view of essential improvements in Canadian productivity and competitiveness, the Committee considers that the essential point to understand is that the interests of the Canadian consumer can be protected by import competition as well as by internal anti-combines legislation. As Mr. Ian Rush of Polysar pointed out, while his firm had a virtual monopoly in the Canadian market for synthetic rubber products, there was no lack of competition from imports. When the level of import competition has increased so greatly and will progressively increase with further trade liberalization, it is no longer appropriate or necessary to assess the degree of competition which exists solely in terms of the number of domestic producers.

Nor should new Canadian legislation be modelled on U.S. anti-combine laws. Profesor Lawrence Skeoch made the point that anti-trust action in the United States does not prevent U.S. corporations from remaining large and strong producers. The Canadian situation is entirely different. The difference is one of size. Fifteen per cent of the U.S. market—the target figure which the most ardent American authorities consider U.S. companies should not exceed—represents 1½ times the entire Canadian market. Canada needs strong corporations with a large share of the domestic market to compete abroad. The Committee is disturbed that a Canadian controlled company like Northern Telecom which is succeeding in the strongly competitive, high technology market in the United States and elsewhere should be faced with the prospect of being divested from its important affiliate, Bell Canada. A more promising development which recognized the need for rationalization in the Canadian manufacturing sector is the decision of two companies, CGE and GSW, to join in forming a single company, CAMCO, to make household appliances. The government appears to have supported and endorsed this joint venture.

To summarize, alteration to the Competition Act could provide some stimulus and assistance to the much needed domestic rationalization. **The Committee recommends the modification of Canadian competition policy to provide a conducive climate for rationalization of Canadian manufacturing production.**

It must be recognized however that the prospects for domestic rationalization, even under a modified competition policy, will be inhibited by the high degree of foreign ownership in the manufacturing sector. Subsidiaries of U.S. companies would be wary of undertaking mergers or co-operative arrangements in Canada which might place parent firms in the United States in danger of anti-trust action. Even though recent changes in Canadian law have expressly excluded subsidiaries from the effect of U.S. anti-trust law in Canada, many U.S. subsidiaries have shown a reluctance to rationalize. This probably stems not only from uncertainty about the actual protection offered by the Canadian law, but also from a natural reluctance by

* Another Senate Committee, the Standing Senate Committee on Banking, Trade and Commerce is undertaking a more lengthy study of the proposed competition legislation.

competitors to join forces. The same inhibitions can be expected to deter U.S. subsidiaries in Canada from agreeing to joint ventures or other forms of collaboration with major foreign competitors. Additional inducements will be needed.

It has been suggested that the government itself should take an active part in bringing about mergers of Canadian companies, in effect, forcing rationalization in certain selected and promising areas. The Committee is doubtful if this would work. The initiatives and with them the responsibility must come from the private sector with the government's assistance limited to modifying the environment through legislation and by offering other supportive measures. If the government itself were to take the merger decisions, the economic rationale for the choices would risk being distorted by other concerns such as regional development which the government legitimately would have. Moreover, in industries with a high degree of foreign ownership, forcing subsidiaries to merge contrary to parent corporations inclinations might prove very difficult. While the Committee does not agree with "forced" rationalization, it sees benefit in a program of inducements such as special R & D support for firms in selected, potentially viable, areas which decided to merge.

It has also been suggested that unilateral free trade would be an effective way of spurring domestic rationalization in Canada. The pressure of cheaper imports would force companies to reorganize into more efficient large scale producing units to survive. However, it is doubtful whether the rationalized firms' share of the domestic market, particularly if it were eroded by imports, would provide a sufficiently large market to achieve the desired scale production. Exports would normally be essential, yet unilateral free trade would offer no improvement in access to the United States or other markets. Moreover, in such a situation many U.S. multinationals might choose to phase out their subsidiary operations in Canada and supply the Canadian market from south of the border locations. Another problem is posed by the uncertainty of demand by Canadian consumers. Would they choose the Canadian product in the face of a wide variety of imported products? If not, the objective of a large Canadian market base would be unachievable. The unilateral free trade approach does not appear to offer the solution.

Finally there is the question as to what effect bilateral free trade with the United States would have on rationalization. Clearly with no tariff protection, Canadian manufacturers would feel the pinch from lower cost free access imports. In effect they would be stimulated to merge in order to survive.

The fragmented structure of Canadian industry requires restructuring and reorganization, in particular a rationalization which will result in longer efficient production runs in key import-competing and exporting industries. The situation will become particularly urgent in the event of a GATT agreement on the multilateral lowering of tariffs. Government competition policy should provide a conducive climate for increased rationalization. **The government should encourage rationalization to the point of offering inducements but should not force mergers.**

(ii) The Need for More R & D

Improvement in Canadian industrial performance requires the continuous introduction and successful implementation of new production and marketing techniques.

The flow of new ideas capable of affecting productivity and improving domestic sales and exports depends in part on the research and development (R & D) activities of the firm, as well as that of supplying firms.

By international standards the performance of Canadian industry in developing a vital indigenous technical competence is poor. In 1970 the Senate Special Committee on Science Policy reported on Canada's unimpressive innovative record in industry. In an international comparison of ten countries for location of 100 significant innovations since 1945, for monetary receipts for patents, for number of patents taken out in foreign countries (year with comparable data was 1963), and export performance in research-intensive product groups, Canada ranked between eighth and tenth. By 1977, this same Committee found that no significant improvement had taken place and the Canadian technological gap for industrial innovation appeared to be widening.

As a nation, Canada spends about one half the proportion spent by other industrialized countries on R & D. Furthermore, its spending on R & D is declining in relative terms; from 1.29 per cent of its Gross Domestic Product (GDP) in 1967, Canadian R & D expenditures declined by 1975 to 1.1 per cent and by 1977 to .92 per cent. By comparison, the United States spent 2.3 per cent in 1975 of its much larger GDP.

The record for patents filed by Canadians is also revealing. In 1974, Canadian nationals and residents filed only 5.7 per cent of the total patents filed in Canada. This percentage is very low compared with 73.1 per cent for Japan, 69.5 per cent for the United States, 38.1 per cent for France and 23.5 per cent for the United Kingdom. Of the approximately 20,000 patents granted annually in Canada, 95 per cent are granted to foreigners, of which three-quarters are Americans.

In view of these statistics, it is not surprising that Canadian high technology industries have failed—with some notable exceptions—to keep pace with those in other industrialized countries. The fact is reflected in Canada's export performance in high technology fields. A recent study of 19 Canadian higher technology industries revealed that between 1970 and 1975 the balance of trade had deteriorated very significantly in 18 of the 19 examined. This group comprised a fairly broad spectrum of industries including chemicals, fibres, machinery, and communications equipment. The only industry showing a favourable balance in this period was petroleum. Yet it is the advanced high technology industries which hold the most potential promise.

The Canadian Manufacturers Association pointed with concern to the continuing decline in the ratio of Canadian industrial R & D to GDP and testimony from individual Canadian industrial representatives also showed a recognition of the need for innovation and increased R & D. Despite this awareness, the actual part played by Canadian industry in the overall industrial research in Canada is dismaying. In many industrialized countries, industry performs about 60 per cent of the total national research effort. In Canada, industry accounts for only one-third of such expenditures and even this is declining. Whereas 1.2 per cent of sales was spent by industry on R & D in 1967, the figure dropped to 0.7 in 1975.

The lack of R & D in Canada is related at least in part to the multitude of small manufacturing plants protected behind the tariff wall. Mr. John Shepherd referred to the fact that there were over 31,000 such small manufacturing plants in Canada with an average of 11 employees. Of these fewer than 5 per cent can afford to do R & D and only 3 per cent really do it. Only 367 companies in Canada have more than six qualified engineers or scientists on their staffs while the average number is two.

Foreign ownership and the branch plant structure of much of the Canadian manufacturing sector were cited as a contributing factor to the poor Canadian record for industrial R & D. In the automotive industry for example, a 1977 government study underlined the minimal amount of R & D done in Canada by the "Big Four" car companies while the Canadian subsidiaries have paid out over \$230 million annually in the past six years to the parent companies for this purpose.

Some subsidiaries of foreign-owned multinationals are, however, doing considerable research in Canada. Mr. Walter Ward of Canadian General Electric said that his company had between 800 and 900 scientists and engineers working in development, research and design. In 1974, this company spent about \$12 million on R & D, and \$101 million over a 10 year period. Although this firm imports much more technology than it exports, Mr. Ward said it was a "two-way street" with the export part growing. However, the location of the head office of multinational companies is not decisive in deciding the location of R & D. Some Canadians-owned multinationals such as Massey Ferguson do a large part of their R & D in the United States and others such as Moore Corporation do all of their R & D there.

What can be said is that firms which have substantial R & D programs in Canada have also experienced success in their exports. Northern Telecom and its affiliated Bell Northern Labs spent \$100 million in 1976 on R & D or 7 per cent of sales. Alcan and Polysar both reported large research programs, in the latter instance amounting to 2.5 per cent of sales. One small Canadian firm, Dominion Road Machinery, made a surprising R & D expenditure with excellent results. Mr. Bruce Sully said his relatively small company which has sales of \$50 million, spent more than \$2.5 million over a six-year period researching and developing an improved road grader which subsequently became a major export success in competition with the product of giant U.S. companies. These are positive examples of what can be achieved, but the overall Canadian R & D performance is lagging badly.

Incentives for Industrial R & D

The lack of industrial R & D in Canada is not an easy situation to turn around. Governments have tried a variety of incentives over a considerable period. For almost 40 years firms have been entitled to write off 100 per cent of R & D expenditures. In 1962 companies were permitted to deduct a further 50 per cent of R & D expenditure from their income for tax purposes; current expenditure was limited to additions beyond the 1961 level of spending, but capital expenditure was not limited. In 1967 this program was dropped because it was judged to provide insufficient

control and was replaced with government support grants such as IRDIA (Industrial Research and Development Incentives Act) and PAIT (Program for the Advancement of Industrial Technology). But all these incentives were to no avail. As the record indicates, the situation has steadily deteriorated. And it became evident that IRDIA grants were being used to a large extent by companies already active in R & D. For example, between 1970 and 1975, 10 firms received 40 per cent of the total grants.

The most specific proposal put to the Committee was made by Mr. Robert Scrivener of Northern Telecom when he appeared as a witness in 1976. He suggested that Canada return to a policy of providing tax incentives for R & D rather than make grants. Subsequently, many of the large companies giving testimony supported the suggestion. Mr. Scrivener argued that tax incentives would encourage efficient and profitable R & D expenditures and that the grant system had provided an insufficient discipline on the management of R & D. Northern Telecom subsequently argued that a tax credit to be really effective must be of a size that will generate vastly increased R & D activity and it suggested a credit of 20 to 25 per cent.

The government has in the interval taken several initiatives to spur innovation in industry, three in 1977 and another two early in 1978. The 1977 measures involve the widening of the "contracting out" policy under which a larger portion of the government's requirements for research and development would be done by industry rather than in the government's laboratories; an Enterprise Development Program which provides direct assistance from the government for a wide range of R & D proposals originating with companies; and a tax-based incentive offering a 5 to 10 per cent investment tax credit for expenditures by industries on R & D between March 1977 and July 1980. In the April 1978 budget an added stimulus, introduced for a 10 year period beginning in 1978, allows companies to deduct 50 per cent of additional R & D expenditures from their income for tax purposes on top of the 100 per cent already permitted for all R & D. The deduction applies to both current and capital expenditures to the extent that they exceed the average amount done over the preceding three years. This is similar to but less generous than the measure in force from 1962 to 1966. Finally in June 1978 the Minister of Science and Technology announced additional measures—more funds for contracting out research, federal support for the creation of five university-based industrial research and innovation centres, increased funding for the three university grants councils and expansion of the National Research Council's program of industry-laboratory projects. The Minister also stated that the government hoped to see R & D expenditures rise to 1.5 per cent of GDP by 1983.

These measures are welcome evidence that the government is at last concerned about the amount of R & D being done in Canada. The new programs place some reliance on the tax system, which is the most supple instrument and they put responsibility in the hands of industry. At the same time, the Enterprise Development Program maintains and broadens the government's capacity to support through direct grants, smaller companies which may lack financial resources or sufficient profit to derive benefits from tax incentives.

It would only be realistic, however, to recognize that there are limitations to the amount of industrial research and development which will be done in Canada as

compared to the United States. For many U.S.-controlled subsidiaries in Canada, government support policies may be largely ineffective. Professor Ray Vernon, a Harvard expert on multinationals, told the Committee that he thought U.S. multinationals would be almost impervious to Canadian tax incentives designed to attract more R & D to Canadian subsidiaries. Furthermore, the very nature of R & D, he said, leads to its concentration in one place. Because of the early U.S. lead in the creation of multinationals, there has been "a gathering up of critical R & D in the United States", he said. (II, 12:36). Even a Canadian multinational company like Moore Corporation finds compelling reasons to do its research in the United States rather than Canada. Mr. Donald Dunlop, Treasurer of the company stated.

"The development of expertise and know-how in our particular industry and our company has been generated for many, many long years, principally in the U.S. market place. This is where we have our people resource. This is where all the new ideas are generated to service business with better methods of doing business. I doubt very much whether a tax incentive would cause us to change the location of where we are doing our research." (II, 15:36)

Northern Telecom had a somewhat similar outlook. Although the bulk of its research personnel are in Canada, recently it established an R & D centre in Palo Alto, California. Mr. Scrivener explained the reasons for this decision:

"... that is where the talent is. There are more people who are expert in integrated circuitry technology and software technology in that part of the world than anywhere else. What we are doing, in effect, is going fishing where the fish are". (II, 3:22)

Mr. William Eberle of the U.S. Motor Vehicle Manufacturers Association confirmed that the major research centres on the continent were in California, around Palo Alto, Berkeley or Stanford in California, in the Chicago-Detroit area and in the Boston area. Each of these areas has different skill concentrations. "It is important to recognize", he said, "that we go to those institutions where the expertise is". (II, 17:24)

Not only will there continue to be a drawing to a few centres in the United States of multinationals' R & D facilities, but even in Canada R & D is likely to concentrate in a very few places. The 1977 investment tax credit does not appear to recognize that U.S. experience which has resulted in the concentration of creative talent into a few nodes should be an important example for Canadian policy. Any attempt to push Canadian R & D into regionally diversified centres should be resisted. Yet this is what the 1977 Canadian investment tax credit scheme tries to do. While there is a straightforward 5 per cent tax credit to companies for R & D efforts, this credit is increased to 7½ per cent if the research is undertaken in designated areas and to 10 per cent in the Gaspé and the Atlantic provinces. In effect, the additional incentives constitute a device to encourage regional development.

In the Committee's opinion, any natural tendency by industry to concentrate its research activity in the optimum Canadian centres should not be influenced by extraneous considerations. It may well be that Halifax, for example, will prove to be a natural centre for R & D work in fields such as maritime research. But such a development should not be artificially stimulated in order to promote regional development simultaneously. U.S. experience has an important lesson which should not be ignored—good research requires concentration of effort, not diversification.

This means that the objective of increased R & D and the objective of regional development should not be pursued by the same incentive. Canada's need for improved R & D is too pressing to permit an incentives policy to be used for other purposes. The regional development weighting should be abandoned and a straightforward R & D incentive given.

It is too early to judge what effects the 1977 and 1978 incentive programs will have. The Minister of Finance claimed when introducing his 1978 budget that Canada's tax treatment of R & D had become "one of the most generous in the world". It is true that the most recent measure to allow firms to deduct 50 per cent of additional R & D expenditure from their income for tax purposes represents a useful incentive for companies which have done relatively little or no R & D in the past. However, it offers no incentives to firms which already have a large program of research unless they have reason to increase their activities in this field. Only the modest 5 per cent tax credit of 1977 with no base period will be of benefit to such firms, and it is open for question how much stimulus there is in a 5 per cent tax credit.

The emphasis in this chapter has been on new R & D. For a country like Canada, it may be as efficient and far less costly to acquire and adapt technology developed outside of the company and even outside of the country. This is an approach which the Japanese have mastered. But in order to be aware of opportunities and to modify them, companies must have active R & D programs.

It will be important to monitor the impact of these new measures to encourage effective industrial R & D in Canada leading to innovative exportable products. The provisions of the 1978 tax incentive are in fact less generous than the similar measure in force between 1962 and 1966 which was not conspicuously successful. This must lead to scepticism that the government's target of 1.5 per cent of GDP by 1983 will be achieved, particularly since its estimates assume that industry's share of R & D will increase at 19 per cent per annum. The pull of the large centres of research in the United States and the problems posed by foreign ownership are difficult to overcome. The several measures involving the National Research Council, the university grants councils and university-based research are unlikely to promote the 'in-house' industrial R & D which must be linked to efficient production and marketing if it is to succeed. They may, however, enhance the research environment in certain major centres in Canada within which industry must work.

The Committee concludes that no matter what trade policy Canada adopts, higher levels of industrial R & D are essential. In order to achieve this objective, it may be necessary to offer industry greater tax incentives than those recently introduced.

(iii) Government Procurement

Another suggested method for strengthening the Canadian secondary manufacturing industry was to use government purchasing powers more effectively. Mr. John Shepherd of the Science Council of Canada argued that by the "harnessing" of federal and provincial procurement, certain areas of Canadian industry could be stimulated, even reorganized. Government policy, he said, should be directed to building the kind of market base that Northern Telecom has with Bell Canada.

"... government itself is a market. It generates a huge amount of spending power which normally has been exercised without reference to industrial strategy. So government itself, in many areas such as energy, is a massive buyer and organizer of the market. My plea there is that when government is a customer, it should structure its spending to make sure that Canadian industry gets the job and not others." (II, 18:24)

Examples he cited were in the nuclear and utilities fields.

A number of Canadian manufacturers referred to the advantage which they perceived U.S. producers had from the Buy American Act and they regretted there was no equivalent in Canada. In fact, while it is true there is no Buy Canadian Act, Canadian federal procurement policy already strongly favours Canadian suppliers. The bulk of federal purchasing is conducted by the Department of Supply and Services (DSS) and its practice is normally to buy in Canada except where a product is not available or significantly more expensive than comparable foreign goods. Only in this event are non-Canadian suppliers invited to tender. This practice is not specified in legislation; it is based on administrative procedures determined within the department and approved by the government. The results are to be seen in the relatively low percentage of purchases of defence and non-defence goods by the Canadian federal government in the United States—7.2 per cent of total federal purchases in 1974-75 and 6.6 per cent in 1975-76. (II, 32A: 6). To some degree, these figures overstate the extent of manufactured products procured in Canada, since foreign produced goods handled by Canadian distributors are treated as if they were made in Canada. Also, the percentages of foreign procurement would increase sharply when large items, such as the long-range maritime patrol aircraft, are bought from the United States. Overall, however, the figures indicate that the federal government already makes most purchases in Canada.

In the defence field, Canadian procurement is shaped by the Defence Production Sharing arrangement with the United States which involves an open tendering system on a continental basis by both countries. Mr. Shepherd urged the increased use of Canadian government defence funds to strengthen the Canadian aircraft industry. However, as will be described more fully in Chapter VI, the federal government already asks for extensive offset production in Canada as part of its large purchases, a practice which funnels orders to Canadian industry and to which the U.S. government authorities from time to time have raised objections. Mr. Shepherd would probably like to see the government go further, decide on an aircraft with an international market potential and then direct the defence forces and Air Canada to buy the aircraft in order to sustain production and raise international interest. This is in effect what has happened with the CANDU reactor. As that experience has demonstrated, the approach is one which can be very costly and involves high risks.

In terms of funds spent on procurement, provincial governments and their dependents—the municipalities, universities and hospitals—are much more significant spenders than the federal government. Together they control 78 per cent of the approximately \$15 billion spent by the public sector in 1974-75 on goods and related services. If crown corporations are included, the federal share rises somewhat. However, the task of coordinating provincial purchases with federal buying is much more difficult in Canada than it is in the United States. It is accepted in the United States that the federal government through its provision of funds to state and local

bodies may specify how the funds are to be used. Canadian provinces are relatively far stronger than the U.S. states and refuse to accept such federal direction. Provinces may, and on occasion, do decide to join in co-operating with the federal government in agreements for joint procurements if they see a benefit in doing so. However, there is a contrary trend prevalent at the present time, the result of political pressure within provinces, for increased provincial procurement, which further fractures the national market. There is, for example, an inefficient proliferation of wire and cable plants in most provinces in Canada, reflecting the procurement powers of provincial hydro corporations.

If services, which include such activities as engineering, repairs or moving expenses, are separated from goods procured, it emerges that federal, provincial and local governments together in 1974-75 spent under \$5 billion on the purchase of goods. Of the 77 classes of goods bought, the largest was \$560 million for fuels, lubricants and oils. This class of goods and many others represent standard products whose manufacture involves routine technologies. In short, the capacity of various levels of government to promote industrial development through purchases of high technology goods is limited.

As part of a recent government policy to encourage more R & D in Canada, a June 1978 announcement by the Minister for Science and Technology indicated that future government purchases of goods and services would favour those firms which had a Canadian R & D program. Among foreign controlled companies preference would be given to those whose parent companies provided autonomy to their Canadian subsidiaries for technological product lines. In support of his proposals the Minister is reported in the press as stating that federal procurement included \$1.3 billion of high technology products.*

The government's objective is a commendable one. There are certain fields of high technology in which government purchasing can indirectly recognize and support R & D; medical equipment and communications equipment could be added to the nuclear and utility industries as examples. But advocates of such a policy tend to understate the problems and overstate the figures. Mr. Shepherd, citing the huge spending programs of utilities as an area for cooperation, did both at the same time.

"I have no doubt in my own mind that when utilities can spend perhaps \$25 billion between them on new programs for Canadian technology that that purchasing must be directed to building an industrial base . . ." (II, 18:37)

Mr. Shepherd has grouped more than one year's spending into his example, and it assumes a coordination of provincial purchasing which does not exist.

The Minister's statement likewise appears to overstate the federal potential to influence high technology production through procurement. He spoke of high technology purchases of \$1.3 out of \$4 billion of purchases. In fact, in 1975, total federal procurement for goods and services was \$3.6 billion, and of this figure, approximately two-thirds was for related services. Thus federal purchases in 1975 for all types of goods (as distinct from services) amounted to about \$1.2 billion, and the majority of these purchases were for standard items, such as fuel or furniture. Only

* *Globe and Mail*, June 2, 1978

if the purchases of all crown corporations were to be included and controlled, could the federal government's purchasing of high technology have the significant impact implied by the Minister.

Canada therefore cannot hope to emulate the success of a country such as Sweden, which has made creative use of its procurement program. Sweden is a unitary state, with a large military budget and its government disposes of a higher proportion of the GNP than almost any other industrialized non-Communist state.

The government has by its 1978 "Shop Canadian" program attempted to focus the attention of Canadians at all levels on the desirability of buying Canadian goods. The Minister of Industry, Trade and Commerce explained one of the government's aims.

"Canadian export manufacturers will also benefit from increased sales. The economies of scale will make their products more competitive in foreign markets. As well, they will be able to take advantage of technological advances as they increase their production runs."

If this program succeeds in making individuals as well as procurement officers in companies and in governments at all levels more aware of the need to support and strengthen Canadian industry, so much the better. The announcement by the Ontario government that it would give up to a 10 per cent preference on purchases of Canadian-made goods made by its ministries, agencies, boards and commissions is a welcome development. At the corporate level the program could have beneficial results if it caused re-assessment of the long established cross-border procurement by some multinational firms and stimulated them to look for Canadian replacements. Yet unless the price and quality of Canadian goods are competitive, the "Shop Canadian" program is unlikely to have a very large impact on consumer buying, a reaction which was immediately voiced by several large merchandisers in Canada.

The Committee concluded that government procurement in Canada as a policy instrument for restructuring, reorganizing and strengthening the Canadian secondary manufacturing industry, cannot be relied upon to play a major role. Nevertheless, coordination of purchasing by federal and provincial governments and their dependencies should be pursued vigorously by the Department of Supply and Services in selected fields of particular Canadian competence and requirement as is already being done in the field of nuclear energy for example. There are undoubtedly some benefits to be gained, but the limits must be realistically assessed. To the extent that the purchases of crown corporations can be integrated into these arrangements, the potential benefits could be increased.

e) The Machinery Industries

Too little attention has been paid to the particular problems of the machinery sector of Canadian manufacturing which is responsible for such a large portion of the end product imbalance of payments. Canada's deficit with the United States in machinery trade is considerably larger than in the automotive sector—\$3.1 billion in 1975 and \$3.5 billion in 1976. Indications are it may continue to deteriorate. A separate discussion of this sector is therefore merited. (Machinery dealt with in this category comprises machinery and equipment used by Canada's resource, processing and manufacturing industries including mechanical equipment for power generation.

It includes agricultural machinery and equipment. It does not include electrical equipment nor transportation equipment of any kind.)

Canada is a massive user of machinery. The total Canadian domestic machinery market in 1975 was \$8.8 billion, a figure which, on a per capita basis, is double that of the United States. Total Canadian imports of U.S. machinery in the categories being discussed were \$4.3 billion in 1975, rising to \$4.6 billion in 1976. The main contributing factor to such heavy use is Canada's need for large construction and resource exploitation machines. For construction machinery alone, Mr. J. S. Thorp, President of the Canadian Association of Equipment Distributors, told the Committee that Canada was by far the United States' best customer, taking \$839 million in 1975, over three times the amount bought by their next best customer, Brazil.

At the same time the United States is also Canada's best market. In 1976 Canadian machinery exports to the United States were \$1.1 billion, or almost 70 per cent of total exports in this category and included practically every type of machine made in Canada. Considering that exports to the United States represented only 52 per cent of Canada's machinery exports in 1965, this represents a considerable concentration of the export market in the United States, due in part to the linkage between the numerous subsidiary machinery producers in Canada and their U.S. parent companies. Proximity is, of course, another important factor.

Over the past 18 years, starting from a negligible base, growth rates in machinery exports to the United States in several categories have been impressive. For instance, exports of materials handling equipment and machinery rose from \$140,000 in 1960 to \$133 million in 1977; mining and excavating machinery exports grew from \$2 million in 1961 (there were no exports in 1960) to \$106 million by 1977; and plastics industry machinery exports climbed from \$4 million in 1962 to \$82 million in 1977.

Despite these strong rates of growth, exports remain a small percentage of Canadian production, and compare unfavourably with imports. Moreover, because capital spending in Canada during the past three years has been limited, current import levels are judged to be relatively low. They are expected to rise as economic activity picks up and could grow sharply as large capital projects including the gas pipeline from Alaska get under way, all of which could lead to a worsening deficit.

The dilemma for Canadian government policy makers in facing this problem has been the need to keep Canadian users' costs as low as possible for capital machines and equipment, while at the same time providing protection for domestic machinery producers. In 1968 under the Kennedy Round, the Canadian tariff was reduced from 22.5 per cent to 15 per cent. At the same time the government's Machinery Program was introduced under which duty is fully remitted in cases when imported machinery is assessed as being in a "not available in Canada" category. Remission of duty has amounted to more than \$1 billion since the Machinery Program began. Taking these remissions into account the relatively high Canadian tariff (15 per cent) on machinery is averaged down to 7.5 per cent. In addition, the "end use" provision of the Canadian tariff permits machinery imported for use in specified resource industries such as mining, oil and gas to enter into Canada free of duty, or at a lower rate. Undoubtedly, the Machinery Program has been of

considerable benefit in lowering the price of capital equipment to Canadian users. It also helped to identify opportunities for new production in Canada by matching domestic requirements for specific types of machinery with Canadian manufacturers' capabilities.

However, the Committee heard testimony which questioned to what degree the program had achieved its objective of encouraging the overall development and growth of the Canadian machinery industry. Mr. J. S. Thorp told the Committee:

"... that the Machinery Program has not, insofar as construction machinery is concerned, realized the hopes held out for it back in 1968, at least in respect of developing manufacturing in this country, or in attracting new entrants from the United States or overseas." (II, 9:10)

He said there has been a withdrawal of foreign-owned manufacturers and only a negligible increase in new manufacturing activity. Further, Mr. Thorp questioned the consequences of the provision which makes a domestic producer eligible for the 15 per cent tariff protection on "equipment of a class or kind made in Canada" as long as he produces only one unit. He cited the case of the Canadian subsidiary of a U.S. producer which had added a very expensive machine to its range, thereby automatically cancelling the duty remission and increasing by \$30,000 the machine's cost to Canadian customers. The question was how many such machines are being made in Canada and how much employment was generated by the cancelled duty remission.

Canadian producers also face difficulties in obtaining good distribution for their products in Canada, a highly important aspect of machinery marketing. Mr. R. W. Chorlton of Wajax pointed out

"Canadian distributors prefer by and large, to handle American products. Canadian firms which attempt to start up on their own and obtain distribution across Canada find it very difficult." (II, 9:26)

Faced with higher competitive costs than U.S. counterparts, with increased import penetration and with domestic distribution problems, the Canadian machinery industry is apprehensive for the future. Mr. R. W. Chorlton went on to explain

"There is no doubt in our minds that the Kennedy Round tariff reduction from 22 ½ per cent to 15 per cent resulted in a diminished interest in Canadian manufacturing on the part of the United States and other foreign principals. Any further reduction in tariffs will undoubtedly lead to the slowing down and eventual closing of many U.S.-owned plants as a result of the tariff incentive no longer offsetting the increased cost of shorter production runs. The Canadian market demands the full range of product models and services available to U.S. customers. At the current 15 per cent duty, this has led to a measure of rationalization as higher volume models are produced in Canada, with the remainder being imported from home factories or given token Canadian content, with a resulting decrease in Canadian manpower input. We believe that these production jobs are important to Canada, and any further significant move to a policy of free trade would result in a further serious restructuring of Canadian industry with most—we believe almost all—of the jobs moving south of the border." (II, 9:19)

Despite the impressive achievements of some producers, imports are taking an increasing share of the domestic market—from 50 per cent in 1965 to 60 per cent in 1975. The growing deficit in machinery trade and the vulnerability of the industry to a further lowering of the tariff indicates that some additional stimulus is needed.

(i) *"End Use" Tariff Exemptions*

The provision for importing a range of resource machinery virtually duty free under "end use" tariff items has inhibited the development of machinery manufacturing capabilities in these areas. Yet removal of this special tariff treatment would add significantly to the cost of resource extraction in Canada, the sector of the economy which contributes most to Canada's favourable merchandise trade balance with the United States. In a longer term perspective, however, this is an area in which Canada has in effect offered unilateral free trade without gaining corresponding benefits from the United States. Unless Canada should decide to seek free trade with the United States, **the Committee urges that officials investigate the possibility of replacing the 'end use' exemptions by a more selective scheme which might be either the existing Machinery Program, or an even more selective duty remission arrangement.** Such changes may necessitate negotiations within GATT.

(ii) *A Remission Program, a Possible Remedy?*

While the Machinery Program has reduced costs to Canadian users of machinery and stimulated some indigenous production, it has also encouraged imports. A little-noticed remission scheme exists, however, which is designed to encourage scale production in Canada and indirectly promote exports. First instituted in 1975, this Canadian government program applied to a company's production of a specific sized pleasure boat and has since been applied to companies in several other industries. In the pleasure boat case, remission was granted to the Canadian producer on the customs duty and sales tax paid or payable on new imported pleasure craft to the extent of the amount of additional Canadian "value added" which the Canadian producer had incorporated into his Canadian-based production lines compared to a base calendar year. The ability to import certain product lines duty free enabled the Canadian producer to specialize in fewer lines with longer production runs with the objective of a lower cost product, higher sales, and increased Canadian "value added", i.e., more employment and use of domestic components. Before the remission order, the U.S. parent company had been intending to repatriate production from the Canadian subsidiary back to the United States. In 1976 the Tariff Board assessed the operation of this particular remission order and reported that the company had had a five-fold increase in both sales and Canadian "value added" between 1969 and 1974 and a three-fold increase in employment between 1970 and 1974. Exports rose rapidly and exceeded imports, which also increased. Plant facilities were increased. The Board noted that the program had deterred the U.S. company from closing down the subsidiary and concluded that a measurable and substantial benefit had derived from it.

The Committee recommends that the Department of Finance consider the possibility of offering a duty remission program to individual Canadian machinery equipment producers for particular lines of machinery they might seek to specialize in. As discussed in the pleasure boat case, remission of duty would be granted on imported lines of machinery to the extent of the additional Canadian "value added" incorporated in the machine produced in Canada. In such categories this program would displace the Machinery Program. In the event of a lowering of the protective 15 per cent tariff by 30 to 40 per cent as a result of the GATT negotiations, the

problems of this sector will be intensified. A remission order linked to additional Canadian "valued added" would offer an incentive to a Canadian machinery producer to rationalize his production. While this could lead to some increased costs to users, at least temporarily, the additional, more efficient production in Canada should lead to increased manufacturing, employment and export. Such an approach would coincide with a policy thrust toward the encouragement of indigenous high technology specialization at a time when Canadian market demands look strong with various large capital projects in play. The danger of Canadian subsidiaries of U.S. firms withdrawing production in Canada as the tariff barriers are lowered would be countered by an inducement to rationalization of their production on a North American basis. Successful Canadian-owned companies with no importing or distributing ties might be encouraged to form a relationship with a U.S. manufacturer for such purposes. The possible incentive of such a program toward vertical integration by foreign-owned corporations would be checked by the restrictions of the Foreign Investment Review Agency. The overall thrust would be to so strengthen and restructure the machinery industry that it could resist imports and increase exports.

There are some potential difficulties which would need to be overcome. The setting up of a remission scheme might appear to be easiest when there is a common ownership, i.e., parent-subsidiary arrangement. But there would seem to be no reason why the program could not also work at an arm's length relationship. Care would have to be taken that such parent-subsidiary rationalization did not lessen the possibility of the even more desirable all-Canadian rationalization between two manufacturers in Canada. There is the possibility that the United States could impose countervailing duties on the exported product if a U.S. competitor company sees a U.S. company benefitting from the program through its Canadian subsidiary. However, since the duty remission is not linked to the Canadian manufacturers' exports but to the additional Canadian "value added", there would be difficulty in proving it was a "bounty" or "grant" as required under U.S. procedure. In any case, the remission has the effect of encouraging U.S. exports to Canada and any U.S. manufacturer would be free to enter into a similar arrangement. Similarly, while a Canadian company could charge that the remission program bestowed unfair advantage on the competing company, there should be nothing to stop it from setting up a similar arrangement and asking for that program to be applied to it.

A duty remission program of this kind is complex to operate and not well suited for long-term application. But if a decision were taken to move toward free trade, it would be ideal during the transition period, helping industry to rationalize and prepare for the increased competition.

(iii) *Farm Machinery*

The farm machinery industry in Canada is a special case. It is usually perceived as an area of complete free trade between the two countries. Yet testimony revealed that some Canadian producers of agricultural machinery, particularly smaller companies situated mainly in Western Canada, were at a considerable disadvantage compared to their multinational competitors because of U.S. tariff designations on certain items.

The farm machinery market in Canada is a segment of the North American market and the industry in the two countries is dominated by a few large firms. Three large multinationals, one of which is Canadian, have manufacturing plants in both countries and some large U.S. companies sell farm machinery in Canada but have none of their production here. Despite an increase in Canadian production in the 1970s, the Canadian farm machinery industry has not maintained its share of either the Canadian farm machinery market or of total Canada-United States production compared with market shares in the late 1960s. In 1977, the Canadian deficit on bilateral farm machinery trade was about \$670 million, up from \$170 million in 1971. Most of the unfavourable Canadian trade balance is in tractors and parts. Only for grain combines and parts does the value of exports exceed imports.

Despite widespread assumptions to the contrary, there is no free trade agreement to cover the movement of agricultural machinery and parts between Canada and the United States. The granting of free entry for selected items in this category was a unilateral act by each country, designed to lead to lower costs of agricultural production for farmers. The different definitions in the differing tariff systems in the two countries have resulted in problems. Canada, for instance, allows free entry to all general purpose tractors; the United States allows only tractors "suitable for agricultural use" to enter free. As a consequence of the wider Canadian definition, Canada imports internal combustion tractors on crawlers or wheels for use in resource industries. This specific import represents 20 per cent of the total Canadian construction machinery market, worth \$200 million. Mr. J. S. Thorp of the Canadian Association of Equipment Distributors remarked that it was understandable that the manufacture of such items in Canada had never been seriously considered. U.S. producers with subsidiaries in Canada naturally locate their tractor production in the United States. Location of production facilities in Canada would mean being penalized by the more restrictive U.S. tariff if they tried to export to the United States.

The main difference in the tariff structures of the two countries, however, concerns farm implement attachments and parts. In Canada, an attachment to a machine, intended for farm use, enters free. In the United States, under Tariff 666.00 there is a more restrictive system whereby the exporter must demonstrate that the *chief* use of the product is on United States farms. This demonstration involves a costly process of documenting usage patterns and of soliciting signed statements from distributors that the item is being used by their customers primarily for agricultural purposes. Canadian exporters* complained to the Committee that even for attachments explicitly designed for agricultural use, such as dozer blades, front end loaders, hydraulic cylinders and shaft monitors, they have been unable to demonstrate in a way acceptable to U.S. authorities that the items qualified for free entry. Yet, these same items enter Canada from the United States duty free.

Another difficulty concerns new products which may have an important potential market on farms as well as for other use. Such products would not be classified as farm machinery in the United States and thus would not be eligible for duty-free

* The Committee received a brief from the Prairie Implement Manufacturers Association which was printed as "Appendix 23A" in the Proceedings of the Committee of June 7, 1977; issue No. 23.

treatment at the U.S. border, whereas the Canadian "end-use" clause would permit duty free entry to farms in Canada.

The difference in tariff treatment is most evident with respect to repair or aftermarket parts and explains why almost all repair parts sold to Canadian farmers are imported. With documentation certifying that the end-use of the part is for manufacture or repair of agricultural equipment, parts can enter free of duty into Canada. In the United States, parts normally have a specific tariff classification, eg. gears, pumps, drive chains, etc. and the listed duty must always be paid, whatever the end-use. It makes no difference that the parts are being sent to the U.S. in order to repair a Canadian-made machine which was previously exported duty-free to that market. For a part that is not specifically listed, it must be shown that it is designed for farm machinery before favourable duty treatment is received.

For a manufacturer, there are locational implications arising out of these differences. Where economies of scale are important and it makes economic sense to supply both markets from one source, an implement or parts manufacturer would pay less duty by locating in the United States a plant which manufactures parts and attachments dutiable in the United States but not in Canada. He can then ship them duty free to Canada. The relevant rates of the U.S. duty are not particularly high, usually between 5 and 15 per cent. But existence of a duty and the manner of its application imposes a costly administrative burden on Canadian manufacturers. Moreover, the U.S. customs authorities are far stricter in auditing the evaluation of an item that bears duty than an item that enters free. A multinational corporation such as John Deere or Massey-Ferguson has the freedom a small firm lacks to structure its production activities to take advantage of the present tariff structure. Mr William Mounfield of Massey-Ferguson, in fact, testified that the present U.S. tariff was not an irritant to his company. However, small national firms represented by the Prairie Implement Manufacturers Association complained that the asymmetric tariff structure discriminated against their growth and provided an incentive, in addition to labour and capital costs, to move their producing activities to the United States.

The Committee agrees with the Prairie Implement Manufacturers Association that Canada should have "the same free access to the U.S. market as U.S. manufacturers have to Canada." (II, 23A:3) It is time this unfair anomaly was wiped out. The problem is how to do this.

Revenue Canada officials assured the Committee that continuous efforts are being made to assist the Canadian agricultural industry in obtaining favourable U.S. classification rulings for Canadian exports. They also indicated that they were pursuing this question with the United States at the Geneva GATT negotiations. However, because of the structure of the U.S. tariff system, modification for farm machinery would have implications for the entire tariff classification. The United States has consciously moved away from the "end use" classification system considering it to be almost impossible to enforce or administer. It would be most unlikely to revive it for farm machinery.

Application of a duty remission program, as suggested earlier in the chapter for other machinery, might provide Canadian producers especially subsidiaries of U.S.

multinationals with incentives to increase the manufacture of parts, attachments or tractors in Canada. However, this would entail cancellation of the Canadian "end use" classification for these items, a move which could lead to higher costs to Canadian farmers for certain products.

A decision by the United States and Canada to grant unconditional free trade for parts, whatever the "end use", would cause other complications. Many parts such as gears, pumps, etc. would be interchangeable with parts used in automobiles and trucks. As such they are classed at present as aftermarket parts under the Automotive Agreement and specifically excluded from duty free entry. Only if the decision was made to extend the Automotive Agreement to cover replacement parts would this alternative appear to be feasible.

The Committee concluded therefore that the most promising and perhaps the only available solution to this problem is the negotiation of a broad and fully reciprocal free trade arrangement in this sector with the United States. The arrangement should specifically include tractors for other than agricultural use as well as the attachments, parts and new types of innovative items now dutiable in the United States. The only significant item of trade on which Canada would have to relinquish duties would appear to be farm wagons and sleds. While such an agreement now is probably too late to have much effect on the tractor production patterns of the large existing multinationals, removal of the asymmetrical treatment would eliminate a pressure on smaller Western firms to move their production facilities to the United States and would encourage more parts and attachment production in Canada. In a free trade arrangement, smaller producers would then be able to enjoy the same economies of scale in Canada now available in the U.S. market.

f) Assistance to Manufacturing Companies with respect to Customs Duty

In order to make Canadian industry more competitive, two procedures—drawbacks and duty remissions—have been put in place which provide for the recovery by or remission to, a company of duty and taxes paid or payable on imported goods. In the Committee's opinion the application of these two procedures could be somewhat improved. A third type of procedure, a remission order designed to encourage domestic production and indirectly to increase exports has been dealt with earlier in this chapter. The proposal for free trade zones is also reviewed.

(i) *Drawbacks*

Under the Canadian Customs Act, there is a provision for a drawback or recovery of duty and taxes by a company under two circumstances. First, if the item is listed in Schedule "B" of the Tariff, a drawback of 50 to 99 per cent is granted depending on the commodity. Tariff item 97052-1, for example, is the authority under which machinery "of a class or kind not made in Canada" when used in automobile manufacturing is granted a drawback of 99 per cent. Secondly, an "export-oriented" drawback is earned by a company for an imported product which is subsequently re-exported, or which is used in the production of exported goods. The rationale is that exporters should not be handicapped in competing for external

markets because of higher material costs created by the tariff. In 1975-76, the Department of National Revenue granted 22,000 drawbacks valued at \$138 million.

There have been complaints by industry that the present system imposes unnecessary added costs for Canadian companies. Reimbursement of duties paid may be delayed over a year from the time of entry, with the result that cumulatively large sums may be tied up and interest charges and inflationary devaluation incurred. In addition, time, effort and cost is involved in substantiating and processing the claim. In certain circumstances, this system may also add to the cost of Canadian goods in foreign markets since, for duty assessments in foreign countries, foreign customs officers sometimes add the duty paid by Canadian firms to their valuation of the Canadian article whether or not a drawback is due. There is, moreover, an automatic loss of 1 per cent of the duty on each item as the drawback is limited to 99 per cent. Canadian manufacturers pointed to the systems of temporary duty free entry which are used instead of drawbacks by several other industrial countries as encouragements to exporters.

The Committee recommends a change in the present drawback to a system providing for duty exemption or remission at the time of entry for goods imported for use in producing exports or for subsequent re-export. The procedure should be decentralized to the point of entry and exemptions granted on the basis of declarations by the importer, subject to stiff penalties for infractions or subsequent failure to re-export. The possibility for appeal or reversal of rulings should exist. This modified system would make a modest contribution to easing the liquidity problems of Canadian exporting businesses and would also save companies some administrative costs, thereby enhancing Canadian competitiveness abroad.

(ii) Duty Remissions

Another rarer type of remission is granted under special orders-in-council to industrial firms. Under such orders, customs duty and frequently sales tax are remitted in advance for a limited specified period on imported goods used for export. The objective is similar to that in granting drawbacks; that is, to increase the competitiveness of exporting firms.

Unfortunately these procedures, involving as they do the approval of an order-in-council, can become tied up in an administrative snarl. One company was advised in June 1977 that it would be advised imminently of a decision. The next communication it received was in March 1978, informing it that a remission order valid from October 1977 to December 1978 had been granted. Unfortunately, by the time of receipt, 5 of the 14 months of the validity of the order had already passed and the benefit was correspondingly reduced.

The Committee considers that the Departments of National Revenue and Finance should investigate what could be done to streamline the procedure for granting the special remission order. Orders-in-council are unwieldy mechanisms in these instances. Ministers are too busy for such tariff details. Since the Customs Act is currently undergoing a major revision, **the Committee recommends that consideration be given to amending the Customs Act to give the remission procedure a legislative basis.**

(iii) *Free Trade Zones*

The Canadian Importers' Association advocated that Canada adopt a system of free trade zones. These zones have been popular in Europe and the United States has established 17 of them. Such zones are administrative areas where goods could enter from abroad, be processed, transformed or stored and re-exported without Canadian customs being involved. Only if the goods were brought from the free trade zone into Canada would duties be levied.

On investigation, the Committee discovered that the U.S. free trade zones were not particularly active. Very little manufacturing is done within the zones. Many of the goods were eventually exported to the United States and not to other countries. The value of goods entering into Canada from these zones appears to be trivial. Likewise Mexico's use of free trade zones seems to be intended primarily to promote social objectives—to discourage further congestion of their already overcrowded cities. With the suggested streamlining of administration, the Committee is satisfied that the Canadian system of drawbacks, bonded warehouses and special duty remissions provides an established, effective alternative to the free trade zones.

3. The Tourist Industry

Canada's deficit in invisibles including services has grown rapidly in recent years. The proportion of the deficit represented by the travel account increased sharply, from 10 per cent in 1975 to 20 per cent in 1976. The main reason for this jump in the travel deficit has been a turnabout in the pattern of travel between Canada and the United States. Until 1975, Canada had a surplus on the bilateral travel account, but that year the pattern was reversed and in 1977 the deficit reached \$770 million. There is concern that this shift reflects major social trends and will therefore be difficult to change.

Beginning in 1975, the number of U.S. tourists coming to Canada dropped for three consecutive years, while the number of Canadian visits to the United States has risen. In 1976 for the first time more Canadians visited the United States than vice versa. At the time it was thought that the U.S. bicentennial celebrations were the cause, but it now is apparent that more deep-seated reasons are involved. Canadians are travelling more and appear to be developing a lifestyle which includes a mid-winter holiday, most frequently in the sun of Florida or California. Americans on the other hand are travelling overseas in ever increasing numbers. Those who continue to come to Canada are finding it more expensive than it had been. Furthermore, witnesses told the Committee there were U.S. perceptions that Canadians were less hospitable and friendly than formerly. The political situation in Quebec was also cited as a probable deterrent to U.S. tourism.

There is little doubt that rising Canadian costs have seriously discouraged visits by Americans. A recent Statistics Canada survey has found that the cost of travel in Canada had increased substantially faster than it did in the United States. Using 1971 as a base year, travel cost indicators in Canada had climbed to 160 by 1978 whereas the figure for the United States was only 140. The Canadian increase was

about 20 per cent higher than the overall rise in consumer prices over the same period.

Witnesses told the Committee that the increase in money wages in the hospitality industry in Canada was much more rapid than the Canadian average. Mr. F. G. Brander, President of the Travel Industry Association of Canada reported that the average wage of \$7,828 in the Canadian hospitality industry was 24 per cent higher than the U.S. figure of \$6,309. Some Canadian regions have been particularly affected. Mr. R. K. Groome of the Hilton organisation reported that wages in British Columbia were the highest in the North American hotel business. He provided figures illustrating the difference in labour costs between Canada and the United States.

"The average wage percentage, expressed as a figure of total income, in the United States runs between 25 and 35 per cent of the total revenue in a hotel paid out in wages. In Canada now there are no major hotels, of which I know, expending less than 40 per cent, and some are spending as high as 45 and 50 per cent of their dollar revenue in wages." (II, 21:39)

The fact that time and a half must be paid after 40 hours of work in Canada as compared to after 44 hours in the United States also contributes to higher labour costs in Canada.

Mr. Brander estimated that menu prices were 10 per cent higher in Canada than the United States and liquor prices substantially higher. The price of a bottle of spirits in some provinces is almost twice what it is in New York State. A particular concern to the industry is that, contrary to what is the case in most parts of the world, none of the provincial liquor commissions offer volume buyers any form of discount and even add delivery charges, a fact which means that hotel and restaurant operators pay more for wine and liquor than the individual consumer does. Higher construction costs and higher financing costs were also cited by the Canadian tourist industry witnesses as adding to the industry's uncompetitive costs in Canada. This fact paralleled the Committee's findings in other sectors. Witnesses also commented on the impediments created by the Canadian customs regulations and practices for incoming convention visitors wishing to import exhibits for display and not for selling purposes. These practices were cited as a discouragement to Canadian locations for conventions.

A strongly voiced complaint from the tourist industry pointed out that the Canadian hotel industry was burdened by a much higher municipal tax rate on hotel rooms than in the United States. Comparative tax rates for 1977 paid in 13 Canadian and U.S. cities are presented in Table 5 on the following page.

This unfavourable discrepancy and its negative effect on tourism has since been acknowledged by both the Ontario and Quebec governments. In 1978 both provinces eliminated the sales tax on hotel rooms, a measure which will contribute to bringing the comparative U.S. and Canadian hotel rates into line.

Taxation of liquor also places the tourist industry at a competitive disadvantage. While provincial jurisdiction over alcohol sales results in a variation of policies across Canada, Mr. Groome's description of the situation in Quebec is fairly typical of that in other provinces.

Table 5

Municipal taxes per hotel room for selected U.S. and Canadian cities

<i>City (rank order of averages)</i>	<i>Lowest Amount Per Room</i>	<i>Highest Amount Per Room</i>	<i>Average Amount Per Room</i>
1. Montreal	\$1,185	\$3,291	\$1,923
2. Quebec City	1,688	1,956	1,842
3. Toronto	677	2,197	1,437
4. New York	481	2,000	1,188
5. Winnipeg	994	1,371	1,143
6. Halifax	749	1,491	1,127
7. Boston	483	1,356	1,004
8. Edmonton	687	1,013	896
9. Calgary	667	951	812
10. Vancouver	443	1,301	790
11. Chicago	465	959	608
12. Philadelphia	160	903	533
13. Washington	166	721	396

Source: Laventhol and Horwath, presented by witnesses from the Travel Industry of Canada in testimony to the Committee May 24, 1977.

"A licence holder in the province of Quebec pays thousands of dollars for his liquor licence and then pays the regular price for a bottle of liquor, plus 5 per cent, and then a 70 cent per case delivery charge on top of all of that. In addition, there is a 10 per cent tax on the retail sale." (II, 21:41)

Witnesses asserted that higher liquor prices were one of the factors making menu prices 10 per cent higher in Canada than in the United States.

In 1975 and 1976, U.S. visitors' chagrin at the high Canadian prices was compounded by the high exchange rate on their dollar when the Canadian dollar's value reached as high as \$1.03 vis-à-vis the U.S. dollar. According to the industry witnesses, this fact made visitors much more sensitive to the service they were receiving and the prices they were paying for meals and liquor. The lower rate of the Canadian dollar since 1977 is bound to have an automatic ameliorating effect on the high Canadian prices in the eyes of the U.S. purchaser. It should also discourage some Canadians from going to the United States or from staying as long.

Finally, a major adverse effect on the bilateral travel account has been caused by Section 602 of the U.S. Tax Reform Act of 1976. This legislation restricts the number of foreign conventions that can be deducted for income tax purposes to two, and imposes much more stringent conditions on reporting of expenditure. Under present U.S. law, a convention is only eligible for a deduction if its location is consistent with the "territorial scope" of the organization. Canada similarly limits the number of conventions eligible for tax deduction to two *but does not discriminate between domestic and foreign-held conventions*. The U.S. restriction and the accompanying stringent reporting requirements apply only to foreign conventions.

Since this legislation was first introduced in the U.S. Congress, groups and organizations that are North American in scope and which have traditionally held

their conventions in Canada on a cyclical basis have been cancelling their bookings. If conventions are shifted to the United States, the tourism deficit is increased, not only by the loss of U.S. business in Canada, but also by the increase in Canadian spending south of the border. The net effect on the travel account of both these factors was estimated to range between \$100 and \$200 million. In respect to this problem, Mr. Brander told the Committee,

"If Section 602 remains in force it will mean a loss of at least the major part of these important conventions, plus the further escape of capital from Canada, as the Canadians who attended what we might call these United States conventions that are held on a cyclical basis in Canada will now be held in the United States, and we will find Canadians going down to attend even more conventions in the United States." (II, 21:15)

Mr. Groome supplied the Committee with details of cancelled hotel reservations by U.S. convention groups in four major Canadian cities which showed that in the first three and a half months after the U.S. legislation took effect, hotels in these cities lost \$24 million.

"If you multiply that by three, which is the generally accepted multiplier of other dollars spent by the convention delegate coming to Canada, including whatever he spends on air fare, taxis, entertainment, shopping, you will come up quickly to a total of about \$100 million." (II, 21:46)

Included among the cancellations were such large and prestigious organizations as the American Newspaper Publishers Association, the Mortgage Bankers Association and the American Bar Association.

The federal government has pursued this issue vigorously with the U.S. Administration, which responded to some degree in early 1978 by proposing to Congress modifications to restore to Canada some of the benefits it formerly enjoyed. However, there is no certainty that Congress will act. Unfortunately the convention tax issue has been linked in the minds of many Members of Congress with a recently enacted Canadian tax amendment (known as Bill C-58) designed to encourage Canadian advertising in indigenous periodicals and television stations. Affected U.S. interests have lobbied and have so far been successful in making the case that the Canadian Income Tax amendment is discriminatory to U.S. interests and that relief to Canada on the convention tax issue should be conditional on Canadian withdrawal of the recent legislative change. This is a complex and politically sensitive situation, but one in which the loss to Canadian interests is many times greater than it is to Americans. **The government must try to find some solution by compromise.**

Remedial measures for the tourist deficit must have two market objectives: first, to persuade more Canadians to travel within Canada, and secondly to encourage more Americans to come to Canada and to stay longer. For both objectives, witnesses agreed that stepped up advertising and marketing approaches were needed. Mr. Brander stated,

"Canada cannot be competitive in the international or the domestic tourism market if it will not increase its marketing and advertising effort. Advertising within Canada and foreign markets must be increased dramatically if the tourism flow crisis that we have now is to be remedied. The federal government must distinguish between "cost" expenditures and "investment" expenditures. The Canadian Government Office of Tourism must be allotted a more adequate budget, in our view. It goes without saying, though, that these dollars must be spent wisely. Market needs must be re-assessed; more programs must be initiated or changed to help ensure that the Canadian tourism plant can compete in a quickly changing marketplace." (II, 21:17, 18)

From 1973 to 1977 the Canadian Government Office of Tourism (CGOT) budget increased by only 19.6 per cent while the Department of Industry, Trade and Commerce's budget increased by 61.7 per cent and the federal government's overall budget by 100 per cent. There is no doubt that it is already recognized that the United States should be the major focus of Canadian government tourist promotion. Mr. T. R. G. Fletcher of the CGOT told the Committee that in 1975 three-quarters of its expenditures (\$12 million out of \$16 million) was directed toward encouraging Americans to travel in Canada and about \$2 million spent to encourage Canadians to travel more within Canada. The Committee considers that these efforts should be not only sustained but upgraded. **The Committee therefore recommends increased funding for the Canadian Government Office of Tourism.** Efforts to encourage increased travel in Canada should be coordinated as far as possible with provincial promotions.

In the area of package tours, Canadian airlines until recently have had a poor record of stimulating cross-Canada travel. Instead they have emphasized almost exclusively the south-bound sun-seeking all inclusive package. The U.S. airlines, however, for some time, have offered advance booking charter (ABC) flights across the United States. They also have all inclusive U.S. ski packages across the United States to western ski resorts of Vail or Aspen and "no frills" round trips have been available on regular air service flights from New York City to Los Angeles on week days at very low rates.

Early in 1978 Canadian airlines began at last to compete with these attractions to a limited extent. Approval was finally obtained from the Canadian Transport Commission for cross-country advance booking charters (ABC). A limited number of charter class Canada (CCC) seats are now available on Canadian internal flights. Air Canada introduced a "no frills" Nighthawk fare for long flights within Canada with no advance booking requirement. Both Air Canada and C.P. Air now have all-inclusive ski packages from Toronto to Banff aimed at the domestic market. Such promotional schemes are long overdue and could help to direct Canadian travel to east-west flows instead of north-south. There are still some gaps, however, in the airline offerings. The ski packages involving both the airlines and the hotels are of a seasonal character. Little is available in the way of an inclusive package tour in the summer which might attract both U.S. visitors and Canadians to plan cross-country Canadian summer vacations.

In summary, considerable recent progress has been made to stimulate the Canadian tourist industry. The new possibilities for cheaper cross-Canada flights are encouraging. The 1978 federal-provincial ministerial decision to promote tourism and package tours was a welcome development. The removal by some provinces of onerous taxes on hotel rooms should assist Canadian hotels in attracting more U.S. and Canadian visitors. The drop in the value of the Canadian dollar vis-à-vis the U.S. dollar has undoubtedly been helpful to this industry. By mid-1978, the forecast was for increased tourist travel in Canada and a reduced number of Canadians going to the United States.

Yet there remains much that can and should be done to improve the situation of this major national industry, whose foreign exchange earnings rank fifth among the

country's industries. It is also a significant employer of labour (88,000 in 1976 directly or indirectly) and this is labour with important special characteristics—offering employment in many remote areas where there are few other opportunities and providing work for unskilled people in many cities and towns.

Together with the Committee's recommendation for increased funding of the Canadian Government Office of Tourism for promotional activities, **the Committee recommends the establishment of a federal-provincial task force to examine all elements of the tourist industry.** It should be instructed to recommend to both levels of government imaginative changes to improve the competitiveness of this fractionated and neglected industry which cumulatively has a major impact on Canada's payments balance with the United States.

The Problem of Minimum Wages

The high level of Canadian minimum wages as compared to those in the United States has adversely affected competitive costs in Canada by creating an upward pressure on wage levels generally. In no industry are minimum wages of more direct relevance than in the tourist or hospitality industry.

As can be seen from Table 6, during the 10 year period from 1967 to 1976 the average Canadian minimum wage measured from about 75 per cent of the U.S. federal minimum to 120 per cent of the U.S. minimum.

Table 6
Indexes of Minimum Wages

	CANADA			UNITED STATES	
	Federal	Composite ¹ (Fed. & Prov.)	Y/Y ³ change in Composite	Federal	Y/Y change
1967	75.7	73.8	4.8	87.5	
1968	75.7	78.6	6.5	100.0	14.3
1969	75.7	86.9	11.1	100.0	0
1970	100.0	100.0	14.9	100.0	0
1971 ²	103.1	108.3	8.3	100.0	0
1972	109.4	116.1	7.2	100.0	0
1973	118.8	126.5	9.0	100.0	0
1974	137.5	146.4	15.7	125.0	25.0
1975	162.5	183.4	25.3	131.3	5.0
1976	181.3	205.6	12.1	143.8	9.5

1. Provincial Rates (90%) are weighted by provincial labour force 1975; federal weight is 10%

2. 1966-71 index is reproduced from Prices and Incomes Commission Report.

3. Y/Y = year by year change (1970 = 100)

Sources: Labour Gazette, var. issues; Final Report of Prices and Incomes Commission; U.S. Statistical Abstract, 1977, p. 411.

In mid-1977, the average minimum wage in the Canadian provinces was \$2.85 an hour, much higher than in many contiguous U.S. states and 15 per cent higher than the U.S. federal minimum of \$2.50 an hour. By 1978 the Canadian federal minimum was \$2.90 and the Quebec minimum stood at \$3.25. Moreover, the U.S. minimum wage legislation has many more exemptions than the Canadian laws, so that the effective differences are even greater than is indicated by the difference in rates. For instance in the United States, small businesses are exempted from paying the minimum wage.

Increases in minimum wage rates have two important impacts. First, they put great upward pressure on wages just above the minimum and, through time, on all wage rates as higher rates are adjusted to maintain long established differentials. Second, increases in minimum wages directly increase costs and reduce employment in low wage manufacturing and service industries. Studies in the United States have concluded that at both the federal and state level, minimum wage legislation has had a negative impact on employment levels.

The industry that is most directly affected by the high Canadian minimum wages is the Canadian hotel and restaurant industry. Mr. R. K. Groome of the Hilton organization told the Committee

"We now have the highest minimum wages in North America. The federal minimum wage, unless I am mistaken, is \$3 and two of the provinces have a minimum wage of \$3 while the highest minimum wage anywhere in the United States is \$2.50 or \$2.60. So we have an automatic disparity in wage levels." (II, 21:41)

Further, in this industry, the impact of the minimum wage is compounded by the low exemption for tipping. In the U.S., the general rule is that a 50 per cent exemption to the employer from the minimum wage requirement is given for tipping revenue. For example, in a state with a minimum wage of \$2.50, a bellman would be deemed to be receiving the minimum wage if he were paid \$1.25 by his employer. In Canada, the allowable deduction is smaller and is deducted from a generally higher base. Only Quebec and Ontario allow any differential at all. In 1976 in Quebec, for an occupation with tipping revenue, the differential has been forty cents on a minimum wage of \$3.15 (for employees over 18 years old). In Ontario, with a minimum wage of \$2.65 per hour, tipping is only taken into account in setting the minimum wage for waiters and waitresses serving liquor in a licensed outlet. For these workers, the minimum wage has been \$2.50 per hour, i.e., a 15¢ differential. The 1978 Ontario budget provided some improvement in the matter of the tipping exemptions, but it is still much more restrictive than in the United States.

Witnesses representing the tourist industry testified that for employees involved in serving food and beverages a tripling or quadrupling of the basic wage rate from tipping was not uncommon. Mr. Groome stated that there are "banquet waiters who earn \$20,000 a year, of which \$12,000 or \$13,000 is gratuities". (II, 21:21) Whatever the general impact of minimum wages on employment and the welfare of marginal workers, the most ardent supporter of this legislation would be hard pressed to justify its augmenting the income of employees that earn as much from tips in the hospitality industry as many employees do.

The original rationale for minimum wage legislation was to better the lot of lower paid employees. Some witnesses questioned that the anticipated benefits of this

legislation have been realized and whether this approach is the best means of pursuing this objective. Mr. John Bulloch, President of the Canadian Federation of Independent Business, summarized this viewpoint.

"To have higher minimum wages in Canada than in the United States is, in my opinion, foolish. There have to be better ways of dealing with the social problems of those who are called our "working poor" than the minimum wage route, which is a very inefficient route. You have situations where, for example, a 60 cents an hour difference between Montreal and U.S. firms that are involved in fairly standardized types of manufacturing simply result in those firms just moving their operations across the border." (II, 22:20,21)

The Federation argued that the minimum wage has reduced the number of jobs available to this group and in particular, many apprentice-style jobs which were low paying, but where the employee was receiving training in a skill that would generate income later, disappeared. The high unemployment rates among teenagers appears to be, in part, a result of the incidence of minimum wage laws. This point of view has recently received recognition from several provinces which have instituted programs to subsidize employers who hire students. Ontario and Quebec for example pay employers part of the wages of a student enabling enterprises to use inexperienced or apprentice-level youth in jobs for which they could not afford the full minimum wage.

Direct comparisons with the minimum wage situation in the United States however ignore the fact that U.S. low-income families are able to supplement their income with food stamps and other benefits. To the extent that the gap between the Canadian and the U.S. minimum wage is narrowed, it will be necessary to supplement the income of low-income families in Canada by direct means. Canadian competitiveness would be better promoted by such an approach rather than having a higher minimum wage in Canada than the United States.

The present disparity in Canadian and U.S. minimum wages has been a factor in raising average Canadian wage levels in the tourist industry to as much as 24 percent higher than in comparable U.S. industry. The legislated minimum levels are, in fact, so far out of line in a number of provinces as to make even parity a difficult objective to achieve except gradually over a number of years. The Canadian federal and provincial legislators should be more aware of the upward pressure effect of minimum wage levels on other wage levels. In order to keep their industries competitive they should understand the importance of keeping an eye on the minimum wages in the contiguous states across the border to ensure that their minimum wage level is no higher. There is no reason why Canada should be a North American leader in minimum wages.

Accordingly, the Committee recommends that increases in Canadian minimum wages be restrained so that the gap with those in the United States, in particular with the competitive northern states, is gradually closed. As movement in this direction occurs, it would be necessary to put in place programs for supplementing the income of low-income families in Canada.

4. Small Businesses

Small businesses constitute the vast majority of productive enterprises in Canada. Although they predominate in the service and tourist sectors, they also

constitute 80 per cent of manufacturing companies. In spite of their very large numbers, however, small businesses in Canada provide less than 20 per cent of all manufacturing employment in Canada and less than 15 per cent of the total value of manufacturing shipments.* Since Canada lacks a legal definition of a small or medium sized business, statistics are somewhat unreliable.

In a number of industries Canada's geographic and demographic make-up favour the producer serving a small local market. Proximity to markets is a crucial element of secondary manufacturing. Transportation costs reinforce this advantage and this factor will gain in importance as energy costs grow, as Mr. John Bulloch, President of the Canadian Federation of Independent Business, reminded the Committee.

"The more efficient types of structures in the future will be smaller enterprises that are more regional than national in their composition because of the growing influence of energy-related transportation costs. There will be a mini-plant movement which should get under way in the early 1980s in terms of efficient, sophisticated, smaller operations that are more regionally located because of transportation costs—brick plants, cement plants, bakeries, dairies, and this type of thing." (II, 22:11)

Over the years, a number of government programs have been put in place to provide various forms of assistance and support, but they have been somewhat random in their impact. More serious from the point of view of the small business community has been the lack of a focal point in government to which they could relate, such as the Small Business Administration in the United States, and which could defend and promote their interests.

Small businesses in Canada face some special problems.¹ Their financial resources are small, so that they find great difficulty in borrowing if they need funds to take advantage of a special opportunity. Paper work demanded by both levels of government can be very onerous. Small Canadian firms complained that many U.S. subsidiaries in Canada were restricted in their authority to subcontract, thereby cutting off an important source of orders.

In order to understand the concerns of the small business community and appreciate its potential in the field of trade with the United States, the Committee invited the Canadian Federation of Independent Business, which was formed a decade ago to represent small business, to testify.

It is interesting to note how many of Mr. Bulloch's concerns were shared by other witnesses from the private sector who represented large firms. These included the need to hold down unit costs, the effect of too-high minimum wages, the cost of borrowing, the over-valued Canadian dollar and, in general, the need to increase efficiency.

The work of the Federation is already having perceptible results in terms of government action. The first major step was the establishment of the Ministry of State for Small Business and its presence has produced action in a number of fields of interest to small business. The time-consuming requirements of government for

* Background study for the Science Council of Canada, April 1973, special study No. 26: *Governments and Innovation*, page 161

form-filling are being somewhat reduced. A program to provide management advice, Counselling Assistance to Small Enterprises known as CASE, has been described by Mr. Bulloch as being "outstanding". A special federally-funded bank for small business, the Federal Business Development Bank (FBDB) has been set up and Mr. Bulloch maintained "it is doing a very good job". (II, 22:23) But the Federation thinks that the FBDB should be the "lender of last resort", and that the primary source of financing should be through the private banks. To further assist small businesses the government has proposed the creation of venture enterprise investment companies (VEICs) with special tax breaks to create pools of risk capital.

Mr. Bulloch drew attention to the high proportion of Japanese exports which are manufactured by small businesses in Japan—40 per cent—and compared this situation unfavourably with that in Canada. While he was persuasive in suggesting that small businesses in Canada had an unrealized potential for export, particularly to the United States, it must be recognized that the strong performance of small business in Japan reflects the strength of its secondary manufacturing industry, an area in which Canada is weak. In contrast, in fields in which Canada has a strong export performance such as automotive products, mining and mineral refining and smelting or plywood manufacturing, only big companies can establish the large capital intensive plants and the integrated production processes.

In response to a question to its membership as to how small businesses in Canada would react to free trade with the United States, the Federation received 10,000 replies. Surprisingly just under one-half supported the free trade idea revealing a much more open attitude to the idea than many large business representatives the Committee heard. Mr. James Conrad of the Federation staff explained the result in these terms.

"The small businessman is prepared to compete with a low tariff situation . . . He operates in a competitive environment; he is prepared to compete; he is prepared to expand his sales in the United States". (II, 22:27)

The need for rationalization and for achieving scale production in Canadian manufacturing industry has been stressed in this report. It is important to emphasize, however, that with modern capital intensive technologies, scale production is not a function of bigness or of large numbers of employees. What is required is specialized manufacture and adequate markets. The Japanese experience with exports by small business suggests that a move toward free trade with the United States could open important opportunities to small manufacturing enterprises in Canada to expand their production and sales. The response of members of the Federation is welcome evidence that they are prepared to face the challenge.

V NON-TARIFF MEASURES

In recent years, non-tariff measures have gained increasing prominence as barriers to trade, often more effective but less visible than tariffs in deflecting imports and much more difficult to bring under international control.* If tariffs are reduced as expected as a result of the GATT multilateral trade negotiations, non-tariff measures will play an even more important trade-inhibiting role. The GATT conference is conscious of this situation and is committed to deal with it as well as tariffs.

Between Canada and the United States, non-tariff measures have until now been less important in shaping bilateral trade patterns than tariffs. This is particularly true in comparison to either country's trade with Japan or the European Community. Nevertheless, a number of non-tariff measures are used by both Canada and the United States. Mr. Tom Burns of the Department of Industry, Trade and Commerce told the Committee "the United States' panoply of non-tariff measures is more of a barrier to Canadians than our panoply is to them." (I, 19:21) A list of some of the more important non-tariff measures notified by each country against the other, under the GATT notification procedure, is set out in Appendix II. They include customs valuations, countervailing measures, quotas, health and safety standards, subsidies and government procurement.

1. Customs Administration

a) The U.S. System

The U.S. non-tariff barrier (NTB) cited most frequently by Canadian officials and businesses as having a notable impact on Canadian exports is the administration of the United States customs. Canadian exporters complained of long delays (sometimes as long as two years) before an official ruling by the U.S. customs administration concerning a tariff classification could be obtained. An official ruling, once obtained, establishes the rate on the shipment in question and provides greater certainty of the rates of duty that will have to be paid on future shipments, since a ruling on a product cannot be altered without due notice and process. Unfortunately, however, a ruling is not applicable to all like products imported by other firms. Each shipper must acquire a ruling to avoid uncertainty over classification. Further, delays ranging from several months to years have been experienced in the processing of entry forms between the time of entry and the appraisal of the goods establishing the duty rate.

* Non-tariff barriers to trade are generally defined as policies, legislation, regulations or practices which have the effect of restraining imports. The definition can also be broadened to include voluntary export restraints and export and import quotas.

Once a rate has been established, the total duty paid depends on the evaluation of the goods. The United States has three methods of evaluation. The "old system" remains in force for a special list of about 1000 products. It values the product at its export or foreign value, whichever is higher. The foreign value is the value at a sales level where *anyone* can purchase it. If different prices are charged to large customers than small, the value for duty purposes would be established at the price charged the small retailer, since, by definition, the discount for large orders is not available on purchases of any size. In effect, volume discounts are ignored. This old value system, which applies among other products to auto aftermarket parts, has the effect of raising the duty significantly. Officials told the Committee that this was one of the principal non-tariff barriers they wished to discuss with the United States at Geneva.

The new U.S. value system covers the bulk of remaining goods. It is less protective but there are frequently costs included in the valuation for duty purposes, which are relevant to some export and domestic sales but not to the particular one being assessed. An example would be costs for warehousing in Canada that did not apply to export sales to the port in question. With both the new and the old system, considerable discretionary scope exists for assessing the value of transactions between related companies or within the same company.

A third system of evaluation, which has received considerable attention from EC industrial interests is the "American selling price" system. However, it applies principally to benzenoid chemicals which are not now an export of Canada to the United States.

b) The Canadian System

The Canadian customs system differs from that of the United States. Most decisions on classification are made by the customs officer at the time of entry. An importer has a right to register an appeal of this decision within 90 days. On rare occasions the Department of National Revenue will change a custom official's decision. It appears that less uncertainty for the importer is generated by this system as compared to the provisional rulings used by the United States.

The Canadian valuation system is based on the fair market value of like goods as sold in the home market of the exporting country. An overriding feature of the Canadian valuation system is that the value for duty must not be less than the selling price to the Canadian purchaser exclusive of all charges on the goods after they leave the point of entry. Quantity and trade level are taken into account in the calculations. The United States has criticized the procedures for valuation when there are no similar trades in the country of origin. The procedure in such cases is to add an estimate of normal profit on such sales to the costs of production. The Americans believe that the resulting valuations are too high. U.S. exporters also complain that they must divulge confidential information to the customs officials—information which could plague them in anti-dumping or countervail suits. That the Canadian customs officers are bound by oath to respect the confidentiality of information provided to them does not significantly reduce this concern. The extent to which Canadian customs officials seek information abroad from exporting companies is unique.

Given the similarity of Canadian and U.S. trading practices and the importance of the trade between the two countries, **bilateral efforts to make the two systems of valuation for duty purposes more similar would be constructive. Codes for reciprocal treatment of similar situations would be easier to negotiate and enforce if the basic systems were more compatible.**

2. Countervailing Measures

The United States countervailing duty law is of major concern to Canada. This law is not fully in conformity with GATT in that it does not require a finding that material "injury" to domestic industry has occurred before an extra duty can be imposed, compensating for foreign subsidies affecting export prices. This variance of the U.S. countervail is technically permissible because the U.S. law pre-dated the GATT provision. However, when the United States extended its law to cover non-dutiable goods in 1974, they were obliged to include the injury provision for these goods.

The injury provision has been part of the anti-dumping code and has prevented some abuses in its application. For example, in 1973, ALCOA lodged a dumping complaint against ALCAN's exports to the United States. Although the Tariff Commission ruled that dumping had technically occurred, no injury was found, and consequently, no anti-dumping duties were levied. For this reason, **persuading the United States to make their countervailing duty law conform with the requirements of Article VI of GATT is and should be an important objective in the present tariff negotiations.**

Another problem with countervailing duty is the ambiguity surrounding the extent of its applicability. General subsidies or tax preferences tied to export performance, such as the duty remission plan on automobiles which preceded the 1965 Auto Pact, obviously qualify. However, *any* tax or subsidy that influences costs will indirectly affect the competitiveness of Canada's goods in the United States.

In 1973, acting on a complaint, the United States Treasury decided that exemptions from municipal tax, aid from Industrial Estates Limited in Nova Scotia and federal regional grants to the Michelin Tire Company represented an export bounty. A countervailing duty of over 6 per cent was imposed; this level of duty adjusts with a number of factors and is now between 2 and 3 per cent. Michelin has so far paid over \$6 million in these duties. The company has continued to appeal the case which is still before the courts. Concerning injury and the pervasiveness of similar practices in the U.S. in this case, Mr. A. V. Peters of Michelin commented:

"When we raised this question of injury in a discussion with representatives of Treasury . . . we were told that it was completely irrelevant. . . . When we raised the question of the assistance available in the United States—in some states, because in the United States it is very often a local question—it was much more extensive than what we know in Canada. The answer was always, 'it is irrelevant'." (II, 24:10)

The Committee considers that an effective delineation between substantive subsidies encouraging export expansion and subsidies which have a minimal effect on export prices and which are elements of programs with other legitimate purposes, must receive high priority in bilateral discussions with the United States as well as

in the multilateral tariff negotiations. In 1977 Canada promulgated its own countervailing duty regulations that are consistent with the GATT articles. Clearly, if the United States substantially widens the application of countervailing duty, Canada will retaliate. Both parties will lose from the resulting contraction in trade and the frustration of legitimate objectives such as regional development.

A retaliatory sequence did start following the introduction of the Domestic International Sales Corporation (DISC) by the United States in 1971. The Canadian government countered with the reduced corporate tax rate for manufacturing industry. In September 1972, it also imposed the Import Surveillance Program designed to identify export-tied tax reductions, such as offered under DISC. As the Committee heard from the Canadian Importers' Association, the Surveillance Program is in itself a hindrance to trade. Importers of goods valued over \$10,000 must provide information on tax benefits received and the extent to which they affect prices. Without such a declaration, goods can enter but a deposit of \$100 per shipment must be posted. The Surveillance Program was prudent preparation for a "countervail war".

The United States government was also preparing itself for such an eventuality. The U.S. Trade Act of 1974 provided a number of wide-ranging powers that could have severely curtailed trade, if interpreted in a protectionist manner. Article XIX of GATT permits emergency safeguard action if imports cause or threaten to cause material damage. In the 1974 law, U.S. procedures under this escape clause became more protectionist with the President having less scope to avoid taking restrictive action, if the International Trade Commission found that imports were linked to injury, either potential or actual. In addition, the President was given powers to act, if another country's commercial policy restricted or discriminated against U.S. trade, if unjustified denial of access to primary goods occurs, if foreign subsidies or taxes unduly affect U.S. commerce, and if "unfair" marketing practices disrupt a U.S. industry. These powers are so all-embracing that there is no longer an effective constraint within U.S. law preventing the President from undertaking protectionist policies. These powers have been buttressed by a substantial expansion of operational staff. One commentator writing in the *Journal of World Trade Law* during 1974 noted that the staff dealing with anti-dumping and countervail complaints had increased by a factor of ten in the preceding two years.

Fortunately, no such "war" has occurred, and the Michelin case has not stimulated a spate of similar cases. Although this has been fortunate for the two countries, Michelin considers itself a casualty of governmental manœuvring. Mr. Peters commented:

"I have the impression that discreetly I am being encouraged to have the company drop its case. In other words, our case is becoming an embarrassment of some sort. Since the realization came that it was a decision against Michelin, it is quite conceivable that reassurances were given that the countervailing duties on that basis would not be imposed on other companies, and everybody seems to be happy but Michelin." (II, 24:9)

Beyond providing information consistent with Canadian law and international protocol, the Canadian Government can provide only limited assistance to an individual company in a case involving foreign law, and has properly concentrated its diplomatic attention on negotiating a more favourable environment for Canadian industry as a whole.

3. Anti-Dumping Measures

As with the countervailing measure, U.S. and Canadian anti-dumping provisions differ because the U.S. law was enacted prior to the formation of an international code under GATT. A potentially significant difference involves the interpretation of "injury". The Canadian law requires that dumping be the *principal* cause of *material* injury; U.S. law only requires that "injury by reason of dumped imports" exist, and the competent U.S. authorities have much more freedom in interpreting what constitutes injury. In practice, however witnesses testified that U.S. enforcement practices to date were similar to the Canadian.

Another difference is that, in the United States, the Secretary of the Treasury can initiate an anti-dumping investigation on the complaint of a single member of an industry. In Canada, the Deputy Minister of National Revenue has to determine whether there is evidence that dumping has affected domestic producers *as a whole* before action is initiated. On the other hand, U.S. law requires anti-dumping action to be taken within a certain time frame. Decisions on Canadian anti-dumping cases have taken considerably longer to determine until recently when guidelines for processing complaints which provide for similar timing to U.S. practice were adopted by the Department of National Revenue. Canadian companies producing for the domestic market have complained of the high cost and long periods of time involved in getting relief. Canadian importers on the other hand complain that the Canadian anti-dumping authorities are over-zealous in regard to alleged dumping.

Between 1969 and mid-1977 Canada investigated 44 anti-dumping cases involving U.S. exports into Canada, approximately five cases a year. The frequency of U.S. anti-dumping investigations has, until recently, been similar. However, the scope for other investigations concerning injury have been substantially widened beyond the boundaries of traditional dumping and countervail by Section 337 of the U.S. Trade Act. Under that section, the International Trade Commission is empowered to counteract "unfair methods of competition and unfair acts in the importation of articles into the United States". Imports may be restricted if a marketing practice has "the effect or tendency . . . to destroy or substantially injure an American industry or prevent the establishment of such an industry". Over 20 investigations, under the powers granted in this section, have been initiated since the U.S. Trade Act became law in early 1975.

On occasion, as during the U.S. automotive anti-dumping investigation of 1975, Canada has complained that U.S. anti-dumping procedures were not initiated in conformity with the GATT anti-dumping code. As the U.S. law pre-dated the GATT code there is no requirement to bring the legislation into full conformity. In the automotive case, one Congressman's complaint on behalf of the UAW was sufficient to launch the case. Canada, along with other countries, contends this does not constitute a complaint on behalf of an "industry" as defined by the code.

Nevertheless, on balance, the situation has improved in respect to anti-dumping. Prior to the Kennedy Round of multilateral trade negotiations, anti-dumping was a very considerable trade barrier between Canada and the United States. According to a Canadian official, the successful Kennedy Round had a positive effect on the U.S. anti-dumping procedures, "eliminating all of the worst excesses". However, the

Committee agrees that Canada should continue to press in the GATT negotiations to have the United States broaden its "injury" provision in anti-dumping cases to parallel the GATT code.

4. Government Purchasing

Because of the increasing importance of government economic activity in North America, government purchasing policy is an important actual and potential deterrent to bilateral trade. Both federal governments favour domestic sources. The U.S. government generally implements the Buy American Act of 1933 by providing a preference margin of 6 per cent for a domestic bid over a foreign bid (including duties); this preference is raised to 12 per cent, if the domestic bidder is a small business. These preferences are, in effect the floor for discrimination and some major departments apply higher preferences. City and state governments generally apply either formal or de facto preferences in their purchasing policies.

In 1977, a bill to extend and strengthen the Buy American Act was introduced in the U.S. Congress. If passed, it would virtually close off access for Canadian products, except for defence, to U.S. federal procurement purchases as well as a large portion of state and local government procurement. For instance, the 6 to 12 per cent price preferences would be raised to 15 and 20 per cent and the amount of U.S. content required would be raised from 50 to 75 per cent. In addition, more stringent controls have been attached to certain state and local projects funded by U.S. federal funds requiring stricter observance of "Buy American" restrictions in purchasing. These U.S. federal procurement measures have been paralleled by a rash of new buy-local-state laws in 1977 and 1978.

As has been mentioned before, Canadian governments also apply preferential margins in their purchasing. The federal government accepts a premium of 10 per cent of the difference in foreign content between two bids. An example, provided by the Department of Supply and Services (DSS), illustrates. Suppose

"... two bids were received from Canadian firms, one at \$100 included a foreign content of \$20 and the \$96 bid included a foreign content of \$80. Thus the foreign evaluation differential that DSS is allowed to work with is calculated by taking 10 per cent of difference between the two foreign contents, i.e. 10 per cent of \$80—\$20, \$6. This \$6 foreign content evaluation differential is then added to the lower bid price, i.e. \$96 plus \$6, \$102 with the result that a contract would be awarded to the \$100 bidder since his bid is competitive on this basis. (II, 23A:5)

Provincial governments generally provide greater preference, either formally or informally, to firms located in the province. The purchasing practice of Provincial Liquor Boards have been cited by the United States in the GATT negotiations as a non-tariff barrier of particular concern to them.

On both sides of the border the domestic preferences are bolstered by a series of other protective measures. In Canada, foreign firms are not invited to bid on many contracts; if the product is required quickly, only local firms may be invited to bid; on some contracts, a minimum Canadian content may be prescribed. In the United States, large contracts are reviewed and decisions may be altered for the 'national interest'. Mr. Allan V. Orr of Atlas Steels told the Committee that foreign specialty steels were excluded from U.S. defence contracts by legislation.

Practices of administrative agencies widen the scope of the Buy American Act. The Rural Electrification Authority lends funds to independent telephone companies at very low rates of interest, but the funds must be used to purchase capital equipment. A six per cent preference is shown to equipment which has a 51 per cent U.S. content. Since Western Electric supplies the Bell System, the independent telephone market is one of the major telecommunication equipment markets remaining. If a Canadian company like Northern Telecom wishes to penetrate this market, it must establish a subsidiary manufacturing facility in the United States.

Location of production, not ownership, is the key to present preference arrangements in both countries. Moore Corporation, a Canadian-owned company, is the largest supplier of business forms to the United States government from its U.S. plants. Mr. Bruce Sully of Dominion Road Machinery acknowledged the impact of government purchasing on his company's decision to build a plant in the United States.

"... it is imperative that our product be manufactured in the United States, particularly since approximately 70 per cent of our business is politically-oriented and, therefore, subject to continued threats to implement 'Buy America Act' and very often strong presentations to 'Don't Buy Foreign!' " (II, 9:15)

Mr. R.W. Chorlton of Wajax, a company which manufactures fire control pumps in both Seattle and Montreal, said that more economical production could be achieved with one plant. However, since state and federal authorities represent the main market in the United States, the company would lose its U.S. sales if production were consolidated in Montreal. With the present less protective Canadian purchasing policies, the closing down of the Montreal manufacturing plant, and consolidation of production in Seattle would be an attractive alternative to the status quo, particularly if tariff rates were lowered multilaterally.

The fragmentation of Canadian production facilities by protective provincial purchasing policies also decreases Canadian cost competitiveness in foreign markets. Where provincial agencies, or crown corporations, or regulated utilities are important customers, pressures to locate production activity in the province are exerted. For a utility company, the provincial governments would be willing to impose an implicit tax in the form of higher utility rates, for instance, in order to subsidize local production. Mr. Alfred Powis, President of Noranda, described the situation.

"A specific province will say, 'We will only buy a certain product if it is produced in this province'. This becomes significant in terms of wire and cable, for example, with regard to which, if you want to sell these products to such a provincial utility as I have referred to, you had better make it in that province." (I, 36:15)

The incidence of government purchasing varies considerably between industries. For most industries, it is not a dominant factor, but for industries such as telecommunications equipment, aerospace, electronics, wire and cable, electric generating equipment, and business forms, it is known to be extremely important. **Rationalization of federal and provincial purchasing policies would be a desirable first step in designing a better code for government purchasing. A second step would be to negotiate mutually advantageous arrangements with the United States in respect to procurement practices.**

5. Packaging, labelling, metrication, building codes and other standards.

Packaging and labelling requirements can also act as deterrents to trade. In the United States, enforcement of the labelling requirements is much more stringent on imported goods as compared to domestic goods. Domestic goods are subject to spot checks while imported goods are examined in detail at border crossing points. The U.S. Government has complained to GATT about the Canadian bilingual labelling requirements on mass produced goods. Country of origin labelling requirements can also be an important cost element for potential exporters. For example, business forms must bear the appropriate imprint "Made in the United States" or "Made in Canada". How this information protects the customer is not clear. It was cited by Moore Corporation as a reason why cross-border trade in business forms was trivial. About ten years ago, U.S. lumber interests supported an unsuccessful attempt to require Canadian lumber to bear a country-of-origin marking.

Metrication requires continuing cooperation between the governments and industry of both countries to avoid detrimental effects on bilateral trade. The Canadian program is more advanced than the U.S. program and the timetables for adoption of metric measures in each industry vary between the two countries. The Canadian Metric Commission has indicated it recognizes the importance of reconciling the Canadian and U.S. programs, and is undertaking negotiations to that end.

In both countries, building code standards, safety standards and grading requirements frequently have a disproportionate effect on imports as compared to domestic products. Tax policies, such as the U.S. treatment of convention expenses abroad, DISC, Western Hemisphere Trading Corporations and regional subsidies are also nontariff measures. Until recently U.S. copyright law contained a manufacturing clause that limited protection to the author unless the book, periodical etc. was manufactured in the United States. Canadian officials actively pursued change in this U.S. law. Recently the Americans withdrew this provision from the law. The change was to occur after a period of five years but Canada was given immediate exemption.

6. Conclusions

There is a very large variety of non-tariff measures which could or do distort trade. Some are blatantly protectionist; others relate to legitimate social purposes such as health, safety, or bilingualism. In a period of economic recession, unemployment or inflation, non-tariff measures represent tempting protective devices because they are often less visible than tariffs and harder to monitor and challenge. In times of economic difficulty, as tariffs are liberalized, the pressure to achieve comparable protection through NTB's can become irresistible.

Negotiators at the GATT multilateral trade negotiations have been attempting to formulate international codes of conduct for various categories of non-tariff measures, namely government procurement, subsidies and countervailing duties, regional development grants, and product and safety standards.

In the GATT negotiations on countervail, Canada is pressing the United States to insert an injury provision in their law and to reach an agreed definition of what constitutes regional development grants before it is classified as a subsidy. DISC is

another issue which may be modified as a result of the Geneva talks. Mr. William Eberle, the former U.S. trade negotiator, told the Committee that the 1974 Trade Act had a provision which obliged Congress to vote on any non-tariff measure agreement within 90 days. Congress could no longer kill such agreements merely by refusing to deal with them as it had after the Kennedy Round.

However there is widespread scepticism as to whether effective monitoring and enforcement mechanisms for some of the international codes of conduct can be established, for instance in the important area of government procurement. Retaliation in one form or another is likely to occur if one country strengthens its measures and remains immune from effective international sanctions.

In view of the difficulties of achieving success in this area at GATT, the Committee is of the opinion that bilateral negotiations with the United States might well prove to be a more fruitful and realistic avenue for Canada to reach a reciprocal and advantageous understanding in this area.

VI TWO SPECIAL CASES OF LIMITED FREE TRADE

The Defence Production Sharing arrangement and the Automotive Agreement constitute limited sectoral free trade arrangements between Canada and the United States. While both programs have been of benefit to Canadian industry and trade, there are currently stresses and strains evident in each arrangement.

1. Bilateral Trade in Defence Products

Bilateral economic cooperation in the defence field goes back to the Hyde Park declaration of 1941. However, the present dimensions of the program were negotiated in the late fifties when it became clear that Canada could no longer hope to be self-sufficient in the major areas of military equipment production. The Canadian government then decided to concentrate on carefully selected areas of defence production in fields in which Canada had special experience and need such as communications, navigation and transportation. In the interests of North American defence, the United States agreed to share its defence technology with Canada and to open the huge U.S. defence market to Canadian manufacturers of military equipment on what amounted to privileged terms. The Defence Production Sharing arrangement, which has been worked out in a series of agreements over the years, offered an economic basis for a specialized Canadian defence industry.

In general terms the Defence Production Sharing arrangement provides for duty-free movement across the border in military goods. The U.S. government lifted the Buy American Act requirement for a wide range of military commodities and removed U.S. duties (from 12 to 17 per cent) for Canadian goods subcontracted by U.S. firms. Canadian tariffs were largely removed in 1966 but to compensate for "anomalies" in the U.S. regulations governing access and to protect smaller Canadian suppliers, duty free entry was only accorded for purchases having a value in excess of \$250,000. The "anomalies" included "small business set asides" which favour procurement from designated small U.S. industries, the "specialty metals" regulation which restricted procurement of items containing specialty metals to U.S. sources and the "no foreign" preference which protects U.S. technology in specific sensitive areas.

Canada also retained a 10 per cent domestic price preference which the United States has periodically cited as a trade irritant. Mr. Frank Jackman, General Director, Office of International Special Projects, Department of Industry, Trade and Commerce characterized it as "discretionary" preference and explained it had been retained

"as a counterbalancing force to some of the other protective devices on the U.S. side and to ensure that at the lower end of the spectrum there is no undue damage done in terms of disparity of size and economic power between firms competing on both sides of the border. It does remain an item which . . . we assume we will continue to debate" (I, 30:24).

In 1963 a balance of payment "understanding" was reached by both countries stipulating that Canadian and U.S. trade in this area should be "in rough balance". Mr. Jackman told the Committee that periodic attempts "to define just how rough is rough have never really met with much success" (I, 30:8). Nevertheless, as long as there has not been too great a divergence, both sides have remained relatively satisfied. Generally speaking, Mr. Jackman said, sales decisions in this area have not been administered but secured through competitive bidding.

When there is too great an imbalance in this bilateral trade, an 'ad hoc' mechanism is brought into play which appears to be one of encouraging and of cajoling. A joint official-level steering committee exchanges views on each country's long term requirements to try to find areas where needs match or where cooperative or joint development in the production of equipment would prove economic. From time to time, when there appears to be too much of an imbalance, the committee decides to take

"a closer look at some of the requirements on either side of the border, to make sure that a firm on one side or the other of the border does in fact seek equipment supply from a producer in Canada or the United States. We tend to, through stimulation of the process, ensure that there is an active shopping on both sides of the border, as opposed to providing direction that 'thou shalt'. Rather than say 'thou shalt', we say 'thou should' " (I, 30:25).

Under the terms of the agreement, Canadian firms can compete for all but the most sensitive U.S. defence contracts. In particular, the program has led to a large two-way trade in subcontracted items. A requisition on a prime contract may be raised by the department of defence in either country and the low bid may come from industry in either country. The successful company will then seek the best source of supply in Canada or the United States for subcontracts. There has been a tendency, which works to Canada's advantage, for firms to establish patterns of procurement and to shop for components in Canada as well as the United States.

During the first 15 years of the existence of this program, that is until 1974, the United States spent over \$3.3 billion on prime contracts and subcontracts in Canada and Canada spent over \$3 billion in the United States, giving Canada an accumulated surplus by 1974 of \$361 million. From 1970 to 1974 the average annual value of Canadian exports to the United States under the Defence Production Sharing arrangement was just under \$200 million, about half of which was in subcontract work.

This program has brought a number of benefits to Canada in terms of employment and technology. Testimony indicated that 10,000 to 12,000 persons are directly employed in manufacturing items sold to the United States and in excess of 100,000 workers are involved at least part-time in the "flow-down effect", that is working in the supplying firms. Furthermore, the jobs provided are at a high level of skill. Participation in this program has also contributed to the maintenance of a manufacturing base in fields of high technology, such as transportation, communications and navigation. By concentrating on installed equipment and avionics rather than airframe items, an official told the Committee, Canada had been able to develop in cooperation with the United States certain specialized items such as a radio relay system which have been widely accepted abroad by Canada's allies. Other technological breakthroughs such as gas turbine technology, sonobuoys and

flight simulators were developed for military use and subsequently achieved success in civilian markets. In keeping with the objectives of the arrangement, there has been some dispersal of the defence industrial base across the country, an advantage for both strategic and regional disparity reasons. There are some benefits in terms of trade with third countries as well since sales by the United States of defence items to other NATO countries may include Canadian-produced components, this can create a subsequent demand for Canadian-made spare parts.

A major and often-cited advantage to the program is the easy access it provides Canada to U.S. high technology. There are, however, problems associated with such ready access. As this report has already discussed, Canada relies on imported technology more than any other industrialized country. In certain defence industry fields, as in many other high technology areas, the effort made by Canada to keep abreast of international capabilities has declined. The Defence Production Sharing arrangement has accentuated this trend because the subcontract work or offset procurement production done by Canada on major U.S. military equipment is produced under licence from the parent firm.

A growing problem under this arrangement relates to the system of offset procurement. In any large purchase of military equipment such as long-range patrol aircraft, Canadian decision-makers tend to look very closely at the amount of component work which the foreign companies will contract out to Canadian companies. It is one of the elements which the various competitors are asked to detail in their proposals. An official told the Committee that the United States has acquiesced in this procedure to try to improve Canadian content on very large purchases.

It is difficult to determine the additional costs that Canada may incur through this system of offset procurement. If it involves setting up relatively short and sometimes duplicate production lines in Canada, the costs will obviously be higher. On the other hand, there can be industrial benefits. In every instance the offset purchase will have some multiplier effect. In some cases, the U.S. manufacturer may make additional sales to third countries and subcontract the new business to the Canadian facility. The Committee considers it would be helpful if more information could be made available on the relative costs and benefits of offset arrangements.

The policy of pressing for Canadian content in offset procurement has had a questionable impact on the vigor of the Canadian defence industry itself. Production done continually under licence, even of highly sophisticated components, does little or nothing to give this industry the necessary viability to get into U.S. or other markets with its own products. It creates an unfortunate dependence on imported technology. Once an offset contract is complete, the vast majority of the additional jobs it created are likely to disappear. In such a system there is nothing to stimulate the development of research-based innovative products. The present situation augurs poorly for the future of the industry. While the original intention of the arrangement was to preserve a viable defence production industry in Canada, it may well be that Canada has already lost the capability to design and produce almost all separate weapon systems and, with that, other important innovative capacities as well.

The arrangement with the Lockheed Corporation for the purchase of the long-range maritime patrol aircraft involved a debateable new form of offset. In

addition to traditional undertakings for the Canadian manufacture of tail assemblies and some other components for up to 150 P3C's (the U.S. version of the long-range maritime patrol aircraft), Lockheed has accepted a legal obligation to secure, during the first 10 years of the contract, \$400 million of new sales of Canadian products, at least 66 per cent of which must be in the aerospace field. The novelty concerns the one-third of sales which can be in any manufactured goods; only raw materials, food and automobile products are excluded. The aim is to take advantage of the enormous buying power of Lockheed (\$35 million of supplies annually, all ordered through a central procurement agency within the company) and of the buying power of the 30 odd major subcontractors, some of which are larger than Lockheed itself. To qualify, purchases must be new or in excess of previous purchases. Moreover, the U.S. importer must pay duty if the item is dutiable. If U.S. components are assembled in Canada, only the Canadian added value is dutiable.

The Lockheed company has mounted a major sales promotion effort designed to sell Canadian products within Lockheed itself and to its major subcontractors. In the traditional aerospace field, it is experiencing no difficulties and is, in fact, ahead of its obligations. In terms of actual sales, 90 per cent of Lockheed's purchases by early 1978 were in the aerospace field. But the company is encountering difficulty in promoting sales in the one third "other" category of manufactured goods. The problem in part appears to be the reluctance of Canadian manufacturers to become involved in a form of trade which is unusual and which they may also fear will not recur. In spite of visits to some 500 companies by Lockheed sales promoters, only 10 per cent have shown any interest by early 1978.

This new technique for tapping the purchasing power of large U.S. corporations through offsets has been resorted to because the market for sub-assembled air frame parts and for aerospace components has been saturated. Other countries purchasing U.S. defence equipment are also insisting on offsets with the result that the room for arrangements in the related aerospace industries may be shrinking.

Another possible solution had been suggested by the Hon. Barnett Danson, the Canadian Defence Minister, in the spring of 1977. He said it would make economic sense if Canada were able to develop and build certain of the equipment needed jointly by the two countries. If the United States would agree to purchase Canadian-made equipment to fill all its needs for a particular item, Canada would be in a position to buy large defence items off-the-shelf from U.S. plants and not have to insist on specific off-setting contracts as a precondition. There would be less duplication of research and development, no added costs for Canada in setting up production lines for its own short-run needs, a North American standardization of military products and Canada would have an assured market for a limited range of high technology goods.

While the proposition is attractive, there are a number of problems. For example, what items would be available for Canadian production in this market? Electronic equipment for NORAD northern communications, coastal patrol vessels and anti-submarine equipment have been mentioned. But would the United States agree that its entire requirement for any significant military item should be procured

abroad, even from a country as closely allied as Canada? Could sales of these items be made in sufficient volume to balance the cost of a major item such as a new fighter?

On balance, the Committee approves the objectives of this idea, but is not optimistic regarding its potential as a solution to the growing problem.

Presumably because there was no positive response from the United States to this proposal, the Canadian government appears ready to repeat the industrial benefits package which it used in the Lockheed case in the purchase of the new fighter aircraft, a larger order valued at \$2.3 billion. This time it is prepared to buy an off-the-shelf model which should mean lower unit costs rather than require the changes which added so much to the cost of the Lockheed Aurora. In exchange, as with the Lockheed order, it is asking for offset contracts in the aerospace industries, in the non-aviation industries making other defence equipment, and in domestic industries which have no relation to aerospace or defence products whatsoever. How this is handled will be extremely important.

The large Canadian order, for 130 to 150 aircraft will undoubtedly justify economic manufacture of certain air frame components in Canada, but this would offset only a portion of the total cost of the fighter. Nor will the saturated aerospace market be able to absorb the balance. Hence, almost inevitably, in following the offset route, the government will look for commitments from the manufacturers to sell other unrelated manufactured goods.

But if there are difficulties in the Lockheed case in finding enough Canadian manufacturers who wish to participate, they are likely to be intensified in the fighter aircraft purchase. Because of the offsets already negotiated under the Lockheed purchase, even the traditional offsets procured in the form of assembly or of component products purchased from the defence or aerospace industries may be difficult to place, particularly to balance such a huge order. Finally, the procedure raises the question of whether the decision on the correct aircraft for Canada's requirements will be skewed by the relative attractiveness of the packages of offset arrangements which different aircraft manufacturers may offer.

In spite of certain deficiencies, the Defence Production Sharing arrangement represents a mutually beneficial means of enlarging trade between Canada and the United States and of extending the range of free, or almost free, trade between the two countries. However, the recent large Canadian aircraft purchases, actual and proposed, have strained the capacity of the system to balance defence trade, which accounts for the complicated and costly offset arrangements written into the Lockheed contract and proposed for the fighter aircraft. Until 1975 the trade was in rough balance—Canadian procurements were relatively low and U.S. procurements were increased by the demands of the war in Vietnam. But that stimulus no longer exists and Canadian equipment purchases are growing rapidly. The balance in favour of the United States was over \$700 million in 1976 alone, and the fighter purchase, if one of the U.S. aircraft is bought, would push the balance far out of line.

The problem of maintaining the agreed "rough balance" is being further complicated by restrictive measures applied by the U.S. Congress. Among such

measures, the U.S. Defense Department issued regulations in August 1977 under direction from Congress which impose new administrative rules on the export of high technology in weaponry. The new restrictions represent a response to the outspoken criticism of some powerful segments of U.S. opinion, including organized labour, on the transfer of technology out of the country. Any muzzle limiting access to high technology would severely affect Canadian firms which depend on subcontracting—especially in the high technology industries such as aerospace, avionics, computers, etc. Raising the issue in December 1977 in Washington, the Minister of Science and Technology received assurances that the new instructions were not meant to restrict technological exchanges with the United States' allies and U.S. firms in competing for Canada's new fighter contract. However, as the new regulations cause administrative delay with subcontracts in Canada there is some risk that U.S. firms may avoid the problem by seeking only domestic suppliers. According to press reports, delays in approval for Canadian firms in U.S. defence contracts have already been experienced and Canadian subcontractors have been faced with some difficulty in getting the necessary information in order to make bids on U.S. contracts. Consultations on the problem are continuing, but the fear remains that the traditional close cooperation in defence production may taper off unless there is some special exemption for Canada to eliminate the bureaucratic approval prerequisite.

Another possible obstacle to the effective operation of the Defence Production Sharing arrangement has been raised by an action of the House Armed Services Committee, which added a rider to the 1979 defence appropriations bill. This provision would prohibit the U.S. Defense Department from buying any equipment from abroad which included foreign produced specialty steel and would largely close off foreign procurement by the Defense Department. A similar measure was passed some years ago and it was only last year that the former specialty metals rider was withdrawn by Congress. It will be several months before the fate of the new specialty metals rider is determined. But in the meantime, it is forcing U.S. aircraft manufacturers bidding on Canada's fighter aircraft order to reassess their situation.

These and other measures could undermine the Defence Production Sharing arrangement. Unfortunately, Canada lacks sufficient leverage to cause the United States Congress to grant a special exemption to Canada. This is in part because other U.S. allies, particularly in NATO, would raise objections unless they were accorded equal preferred treatment. This does not mean that Canada should cease its efforts to have the recent U.S. measures withdrawn or amended so as to exempt a country with which the U.S. had a long-standing defence production sharing arrangement. Canada would, however, be in a much stronger position to be exempted from all such protectionist measures if it were in a free trade arrangement with the United States. **To maintain an effective Defence Production Sharing arrangement, it may be necessary for Canada and the United States to move in the direction of a bilateral free trade arrangement.**

2. Bilateral Trade in Automotive Products

The cross-border flow of automotive products constitutes the largest, most complex and currently the most controversial area of trade between the two

countries. The Committee devoted four lengthy hearings entirely to this subject and two others in which the automotive sector was of major concern.*

As can be seen from the accompanying Table 7, Canada-United States trade in automotive products—the total of exports and imports—surpassed \$20 billion in 1977. This represents one-third of the total trade between the two countries.

Table 7
Canada-United States Trade in Automotive Products

	1975	1976	1977
United States Imports from Canada		(\$ millions)	
Cars	2,858	3,430	4,032
Trucks, etc.	932	1,344	1,964
Parts	2,045	2,942	3,721
Tires and tubes	<u>68</u>	<u>163</u>	<u>144</u>
TOTAL	5,903	7,879	9,861
Canadian Imports from United States			
Cars	2,184	2,321	2,825
Trucks, etc.	942	970	1,123
Parts	4,522	5,474	6,847
Tires and tubes	<u>174</u>	<u>115</u>	<u>153</u>
TOTAL	7,822	8,880	10,948
Balance			
Cars	674	1,109	1,207
Trucks, etc.	— 10	374	841
Parts	— 2,477	— 2,532	— 3,126
Tires and tubes	<u>— 106</u>	<u>48</u>	<u>9</u>
TOTAL	— 1,919	— 1,001	— 1,087

Source: *Statistics Canada daily*, March 15, 1978. A more accurate measurement of trade in automotive products is obtained by comparing the import statistics of each country. Accordingly, figures for Canadian exports are derived from the counterpart U.S. statistics of imports.

No factor has had greater impact on the development of this industry than the signing of the 1965 Automotive Agreement. Prior to the agreement, the trade imbalance with the United States in this sector was reaching an intolerable level. Canadian automotive products manufacturers were in trouble with high costs due to short product runs and the market demand for a proliferation of models. The problems beset Canadian parts producers as well as vehicle manufacturers and the forecast was for an ever-deepening deficit in the bilateral payments account for these products. In the early 1960s the Canadian government introduced a pilot project remitting duty on the import of parts as long as the export of parts expanded by an

* The witnesses included Mr. Roy Bennett, President of the Ford Motor Co. of Canada, Mr. Dennis McDermott, Canadian Director of the UAW, Mr. Patrick Lavelle, President of the Automotive Parts Manufacturers Association of Canada, Mr. William Eberle, President of the Motor Vehicle Manufacturers Association of the United States, Mr. Tom Burns, Senior Assistant Deputy Minister and Mr. Doug Arthur, Special Advisor (Automotive), the latter two from the Department of Industry, Trade and Commerce.

equivalent amount which was measured with reference to a level in a specified year. Spurred by the possibility that the U.S. courts might rule that countervailing duties should be imposed by the U.S. Treasury, the two governments entered into negotiations for a sectoral trade agreement. Access for Canadian-made vehicles was sought and attained to the total North American market. The Automotive Agreement was concluded between the two countries in 1965.

Under the agreement, duties were effectively removed for trade in motor vehicles and original equipment parts although in Canada only *bona fide* manufacturers were eligible for the duty exemption. The U.S. provisions differed from the Canadian in granting free trade for vehicles and parts as long as 50 per cent North American content was contained in the item. The Canadian vehicle manufacturers had to abide by certain safeguards which committed them to increasing their *production* of vehicles by at least a certain ratio to the increase in Canadian *sales* of vehicles. In addition, in separate "letters of undertaking" the Canadian manufacturers undertook to increase the Canadian value-added by at least 60 per cent of the sales growth.

In subsequent debates over particular issues in the bilateral automotive trade, one side or the other turns frequently to the original objectives of the agreement to support his argument. The three stated objectives were:

- a) The creation of a broader market for automotive products within which the full benefits of specialization and large-scale production can be achieved;
- b) The liberalization of United States and Canadian automotive trade in respect of tariff barriers and other factors tending to impede it, with a view to enabling the industries of both countries to participate on a fair and equitable basis in the expanding total market of the two countries;
- c) The development of conditions in which market forces may operate effectively to attain the most economic pattern of investment, production and trade.

Since 1965, a comprehensive restructuring of the Canadian automotive industry has occurred and a substantial integration of Canadian activities with their U.S. counterparts has been achieved. Specialization and rationalization are reflected in a massive growth in inter-country trade, as parts and vehicles flow back and forth between plants located on both sides of the border. In gross terms, vehicle exports have grown relative to imports and the converse is true for parts. Mr. Roy Bennett of the Ford Motor Company testified that about 70 per cent of his company's Canadian-produced vehicles are exported. He explained his view of the advantages of the agreement to the Committee.

"... the real, main lesson to be learned from the Auto Pact is the tremendous advantages that are created for Canada when you do rationalize production and have large economic units of production. In other words, the Auto Pact has led to much greater efficiency in our industry. It has led to a reduction in costs, with a corresponding reduction in the prices of the products."
(II, 7:26)

In 1964, the Canadian deficit on automotive trade accounted for nearly 80 per cent of the total trade deficit with the United States. This deficit diminished during the 1965 to 1969 period and was favourable for the next three years. Since 1973,

Canada's automotive trade has once again been in deficit; in 1975 it reached a record \$1.9 billion. The cumulative deficit for Canada over the 13 year life of the agreement is more than \$7 billion.

Testimony from government officials indicated that under the agreement, Canada as well as the United States experienced substantial employment growth. In Canada, employment in parts and accessories manufacture rose faster than employment in the assembly sector. In relative terms employment in Canada in this sector increased by 56 per cent between 1964 and 1974 and by 18 per cent in the United States, the higher Canadian percentage reflecting the smaller base of the automotive industry in Canada. Mr. Bennett of Ford of Canada claimed that as a proportion of total employment in the North American automotive industry, Canadian employment rose from 8.4 per cent in 1964 to 11.3 per cent in 1975. Subsequently an Ontario government study questioned whether Canada had received a proportionate share of automotive industry jobs.

The realization of optimal scale levels in Canada has resulted in dramatic increases in productivity and in the wages earned in the industry. Nominal parity of wages for Canadian plant employees of the motor vehicle manufacturers was achieved. For the independent parts suppliers, Canadian average wages are still lower than in the contiguous U.S. regions. This is partly due to the fact that there are some non-unionized and low cost plants in Ontario and partly to the different level of skills required in the parts plants in the two countries. However, even here the gap has been narrowed considerably.

Increases in Canadian rates of investment accompanied the major restructuring of the industry. However, much of this investment by the major motor vehicle manufacturers had been committed prior to the agreement, probably stimulated by the Canadian duty remission plan of 1962 and 1963. Compared to the average annual investment levels for 1961-64, assembly investment in the 1965-69 period rose from \$28 million to \$50 million (in constant 1961 dollars) and parts investment rose from \$26 million to \$78 million. The annual averages for the 1971 to 1975 period are lower than those experienced in the period immediately following the conclusion of the agreement but remain substantially higher than pre-1965 levels. Again the increases are greater for parts than for assembly.

In the light of these benefits, the Committee considered that, overall, the agreement has been advantageous to Canada. Nonetheless, problems exist, some the cause of current concern to Canada, some the subject of serious intergovernmental differences and some of lesser seriousness and termed merely "irritants". They have caused a variety of interested parties to question over the years whether the agreement should be renegotiated, amended, even terminated.

At this time the main Canadian uneasiness stems from the persistent overall trade imbalance due to

- the ever-increasing deficit in the trade of automotive parts;
- the lower technological content and less skilled labour component in Canadian industry;
- the almost total concentration of R & D in the United States;

- the price differential;
- the relatively low level of investment in the industry in Canada since 1970.

U.S. concerns have focussed more on employment levels and the price differential. The differences of opinion over whether the safeguard provisions in the agreement are transitional or permanent are discussed in Chapter VII in the context of sectoral free trade arrangements.

Problems Related to Automotive Parts Trade

The thorniest issue arising from this trade relates to the deficit in cross-border trade of parts. As is evident from table 7 on page 95, Canada exports more vehicles (cars and trucks) to the United States than it imports, resulting in a surplus in 1977 of \$1.2 billion in these items. However, the trade in automotive parts* is a different story; these imports exceeded exports by a wide margin, leaving a \$3.1 billion deficit in 1977. Linked to this problem is the concern that the quality of Canadian jobs in the parts industry is not of the same skill mix as in the United States. At the heart of the debate over the parts deficit is the interpretation put on the agreement's objectives that both parties to the agreement should achieve "a fair and equitable share" of the North American market.

The Committee heard a number of opinions on the subject of the parts deficit. Officials of the Department of Industry, Trade and Commerce expressed concern over the widening gap in parts trade. Mr. Doug Arthur explained that part of the reason lay in the fact that the type of parts produced in Canada are being used mainly in assembly plants in the United States which produced the larger, intermediate and standard model cars. Canadian assembled cars tended to be mainly in the sub-compact range and the increase in the U.S. imported parts was a function of the high demand for these cars.

Mr. Patrick Lavelle of the Canadian Automotive Parts Manufacturers Association told the Committee that the shifting assembly production patterns were only part of the answer to the parts trade deficit. He attributed the trouble to a number of other factors including:

- i) the purchasing decisions of the U.S. parent assembly companies which decide where parts are to be sourced;
- ii) more favourable competitive conditions in the United States including wage rates which were lower in the southern United States than in Canada;
- iii) and to the fact that parts are being imported into Canada by the companies from Mexico, Brazil and Venezuela under the most-favoured-nation application of duty free access granted by Canada at the time of the agreement.

Mr. Dennis McDermott of the United Auto Workers suggested that since the Canadian parts producers were not benefiting as they should under the Auto Pact

* This discussion concerns original equipment parts (O.E.M.) which trade freely under the agreement as differentiated from the aftermarket (service or replacement) parts which are subject to duty.

"... government intervention may be necessary... to force the auto majors either to introduce more in-house production in Canada or to expand sourcing from independents in Canada." (II, 26:13)

In particular he referred to the need for increased production in Canada of large stampings, transmissions and power train components. He was concerned that the motor vehicle companies should expand their sourcing from independent parts producers in Canada who, were "treated very roughly by the car manufacturers" (II, 26:30). Mr. McDermott also pointed out the negative impact of the parts which come in from low wage countries by virtue of Canada's multilateral application of the free access provisions. At the time of the agreement, the United States had sought and received a waiver from GATT sanctioning the bilateral free trade arrangement whereas Canada had applied the provisions for free access on a multilateral basis.

Both Mr. William Eberle of the U.S. Motor Vehicle Manufacturers Association and Mr. Roy Bennett said that the industry's trade should not be looked at in two segments, parts and assembled vehicles, but should be taken as a whole. Mr. Bennett linked the surplus on vehicle trade to the deficit in automotive parts. He explained:

"The more vehicles we assemble in Canada, the more components are imported and the larger the deficit in the trade balance in this particular segment becomes." (II, 7:13)

Instead of looking at Canada's gross exports of parts, Mr. Bennett preferred to look at the deficit from the point of view of the net parts consumed in the two countries—"those parts exported that stay exported and the parts that are imported that stay imported". Subsequent to the hearing, Mr. Bennett supplied the Committee with a chart (see Appendix 3) based on estimated data calculating that Canada has, in fact, been a net exporter of parts since 1968. Mr. Bennett explained his procedure:

"To arrive at net consumption, we reduced the gross imports of original equipment parts by the estimated amount of parts included in vehicles assembled in Canada and exported. A similar adjustment was made to the gross exports of original equipment parts so as to deduct parts returned to Canada as finished vehicles. The broken line showing net imports on the chart is labelled 'U.S.-made parts consumed in Canada', and the unbroken line for exports is labelled 'Canadian-made parts consumed in the United States'."

Mr. Bennett acknowledged that the vehicle trade figures would also need to be altered with the consequence that the normally reported surplus in vehicle trade would become a deficit.

There is no doubt that the gross balances of the present trade figures provide an imperfect picture of which activities are generating a surplus or a deficit in the balance of payments. Also, because the back-and-forth flows are simply aggregated, a distorted and inflated idea emerges about the amount of real production in this industry. While Mr. Bennett's method gets rid of the double-counting and is useful when only a broad picture of the total trans-border trade is required, it has serious drawbacks if any separate examinations of vehicle and parts trade is attempted. For instance, it deals only with a portion of the parts trade. It ignores the flow of a) parts made in the United States, installed in vehicles in the United States and then exported to Canada and b) parts made in Canada installed in vehicles in Canada and then exported to the United States.

The Committee proposes a better procedure for achieving not only the broad picture but also a dissected viewpoint of the parts and vehicles trade. This is set out in detail in Appendix 4. Again, a large Canadian deficit in original equipment parts is evident, but it is easier to interpret the source of the deficit. During its examination of the statistical argument, the Committee became persuaded that there is considerable merit in having the disaggregated figures as well as the existing statistical measure of the cross-border trade. Therefore, **the Committee recommends that the balance of automotive trade figures be disaggregated to show the net value of original equipment parts balance and the amount of net Canadian value-added in assembly.** This improved statistical measure should reveal the plight of the Canadian auto parts producers more clearly. On a North American basis the Canadian share of the original equipment parts has been less than the consumption of these parts by Canadian manufacturers. Mr. Doug Arthur of Industry, Trade and Commerce told the Committee that while the Canadian parts industry had grown substantially over the period covered by the agreement, the growth had not matched the growth in consumption of original equipment parts.* In 1975 Canada's share in the North American production of these parts was 7 per cent whereas Canada's share of North American consumption had reached 12 per cent. Canadian parts producers appear to be losing their share of the Canadian market, supplying 29% in 1975 and, after an initial period of growth in the post-1965 period, also appear to be losing their United States market as well.

One part of the answer lies in the fact that the parts industry itself is expanding to cheaper non-union plants in the southern United States, so that Canadian parts producers are no longer competing against plants in adjacent areas across the border. Wages in the southern states are as much as 25 per cent lower than the Toronto area, and U.S. state and municipal inducements abound. Serious as this prospect appears for the future, however, the nub of the problem currently seems to lie in the sourcing decisions of the vehicle manufacturers in Detroit. In 1975, 71 per cent of U.S.-made parts were used in the assembly of vehicles in Canada and 29 per cent Canadian-made parts. The four motor vehicle manufacturers dominating the market make many of their own parts and components in in-house or captive plants. In addition there are eight large multinational parts suppliers. The rest are mainly independent parts producers. Of the \$3.1 billion worth of imported U.S. parts consumed in Canada annually in 1975, the United States motor vehicle manufacturers or their affiliates accounted for 67 per cent or \$2 billion worth and the large multinationals for 22 per cent, leaving only 11 per cent from U.S. independents. However, of the \$1.3 billion in parts sourced in Canada, 39 per cent came from Canadian in-house plants, 36 per cent from the eight large multinational producers' subsidiaries in Canada and 25 per cent from other parts producers in Canada.** In the light of these figures, and the additional fact that products of the in-house plants are the high value items, it is evident that the "Big Four" are the only companies which have the financial and technological capability to modify the existing sourcing pattern to any significant degree.

* His statements were subsequently borne out in a review of the North American automotive industry by a Canadian government task force. The Canadian study was paralleled by a U.S. study; both were set in motion by a December 1974 agreement between Prime Minister Trudeau and President Ford.

** Canadian government task force report, page 144-145.

It is clear that the safeguard provisions of the agreement linking the ratio of production to sales and value-added have influenced the vehicle manufacturers to meet their commitments in Canada largely through assembly, by investment in the labour-intensive vehicle assembly plants. Since the signing of the pact, Canada has had a surplus in assembly trade. While some of the major vehicle manufacturers are apparently close to the minimum commitment levels in relation to production growth, they cannot be accused of failing to honour their undertakings unless it falls below these levels. The main issue would therefore appear to be whether the lagging Canadian parts producers' participation constitutes a valid cause for complaint under the "fair and equitable" objectives of the agreement.

Other Problem Areas

The issue of parts deficit is being aggravated by Canadian concern for the future pattern of production and investment. It is evident that the industry is on the threshold of unprecedented technological change. Whole plants may have to be re-equipped and re-tooled at least once and perhaps twice in the next eight years and some plants will become obsolete. A major shift from steel to aluminum alloys and plastic is foreseen. Radical changes will take place in engines and transmissions after 1980. Mr. Arthur told the Committee:

"The industry will have to meet the mandatory fuel economy standards on new vehicles, as well as engine emission and safety standards. The influences of the energy situation on the consumer, government action spurred by energy problems and regulations relating to safety and engine emission, will have significant impacts on the configuration of the North American automobile. Although manufacturing methods and materials will not change drastically, the industry will have to shift to the use of lighter weight materials which require different fabricating techniques to meet design, manufacturing, cost and weight requirements. Manufacturing will become more automated.

The cumulative effect of these changes will significantly alter the traditional sourcing pattern of the industry. Many materials and parts suppliers will have to adjust to the changing circumstances in this industry if they hope to continue to compete. The development of new types of vehicles, new technologies and standards will require considerable new investment." (I, 24:18)

But the Canadian industry is ill-equipped to participate in these important changes, both in assembly and parts plants. Compared to the more highly skilled, capital-intensive parts plants in the United States, Canadian plants tend to be labour-intensive but requiring lower skill levels to do more conventional production.

The research and development efforts in Canada by the major vehicle manufacturers have been miniscule and the Committee views them as totally unacceptable. In 1975 the "Big Four" spent over \$2 billion on R & D in the United States as opposed to approximately \$5 million in Canada. Yet the Canadian manufacturers have contributed at least \$230 million annually to the research accounts of their parent companies. The location of the bulk of the research facilities in the United States rather than Canada is seen to have a relationship to the acquisition of sophisticated skills and technology by firms operating on the periphery of the auto industry. While it is important that Canada share in the participation of the technological developments, present trends suggest that the more capital intensive activities and the production of the higher technology products will be increasingly concentrated in the United States.

Another concern relates to the low level of investment in the automotive industry in Canada, a level which has essentially stood still or declined since 1970. According to the Canadian government Task Force report, some of the vehicle manufacturers have been operating at close to the minimum levels of growth to which they are tied by the original commitments made at the time of the Automotive Agreement. This raises the question of what their investment pattern might have been without the safeguards or if they had been in place for only a few years. The Canadian subsidiaries of the three major U.S. auto manufacturers are a source of a much higher profit ratio than the U.S. parents. According to Mr. Dennis McDermott the Canadian rates of return approach twice the Canadian average and almost 1½ times the returns of United States companies.

The pricing policies of the companies have been an irritant particularly to the Canadian government. It has been suggested that higher profits from the Canadian operations are related to the price differential charged in Canada and the United States for the same car model. The cost difference has fallen for Canadians from 16 per cent at the time the pact was signed to 6.4 per cent in 1976. That prices would remain higher in Canada than in the United States for a transitional period following the signing of the agreement appears to have been understood by the two governments, but the speed with which price differences would be reduced to a gap which reflected only the different costs of distribution in the two countries has been a source of disagreement. Mr. Bennett testified that there were differences in advertising, marketing and distribution costs between Canada and the United States that warranted a 4 per cent price differential.

In fact, the logic of the manufacturers' car pricing is difficult to follow. The Committee heard evidence giving wide fluctuation in prices both within Canada and between Canada and the United States. For some models in some locations Canadian prices were lower than the prices for the same models in a similar U.S. location. An example cited was a Ford Pinto, the suggested price of which was \$35 lower in Vancouver than in Seattle (adjusted for tax differences). For the smaller cars, the motor vehicle manufacturers have responded to competition from offshore sources by establishing prices on the Atlantic and Pacific coasts at a level below prices at central locations plus freight. Mr. Bennett testified that the actual cost of moving a Pinto from St. Thomas, where they are produced, to Vancouver was \$250 but the prices charged by the company to dealers in the two locations differed by only \$50. It is interesting that the coastal regions which have very little production activity have experienced greater price reductions than the central regions of the country.

Mr. McDermott pointed out another anomaly.

"Another interesting point that has not been exploited too much by those who have appeared before your committee is the price differential that exists on cars between the United States and Canada, regardless of where they are manufactured. To give one example, a General Motors Chevelle Malibu coming out of Oshawa costs 6.3 per cent more if it is shipped to a Canadian dealer as opposed to a U.S. dealer, and that is before any taxation or transportation costs, or anything of that nature, are imposed. Similarly, a Ford Pinto from the Ford operation in St. Thomas will cost 4.2 per cent more if shipped to a Canadian dealer as opposed to an American dealer, and a Ford LTD from Oakville will cost 8 per cent more. Canadians get the privilege of paying that extra percentage!

The Chevelle Malibu will cost 6.3 per cent more; the Ford LTD from Oakville will cost 8 per cent more; and the small Pinto, 4.2 per cent more. The reason for the differential is that those who gravitate towards the Pinto are fairly responsive to the competitiveness of imports. The differential, therefore, is consciously and deliberately smaller on the Pinto than it is on the LTD or the Malibu." (II, 26:8)

The United States Treasury Department in 1975 told the U.S. parent companies that it would initiate anti-dumping hearings unless it received assurances that the prices of Canadian cars would be brought into line with those of similar models in the United States within five years. Apparently it has received the commitment it sought from the manufacturers. As this confrontation took place when the Canadian dollar was at par or above, it will be interesting to follow the companies' pricing policies in the light of the present lower Canadian dollar rate of exchange.

In summary, there are a considerable number of issues and irritants under the Pact; the large deficit in the auto parts trade, the failure to create a number of high technology jobs proportionate with that in the United States, the failure to do any meaningful amount of research and development in Canada, the pricing policies of the companies and the relatively low level of investment in Canada leaving the Canadian industry unprepared for imminent and drastic technological changes. From a Canadian point of view, there are no easy answers to these problems. There is very little leverage available to Canada for persuading either the vehicle manufacturers or the U.S. government to modify the situation.

During the hearings, suggestions were made that the 1965 Automotive Agreement should be renegotiated and amended. Although no witness suggested terminating the pact, voices in the United States and Canada have spoken in such terms when issues flared up. The agreement can in fact be terminated on 12 months' notice by either side. The Committee specifically heard suggestions from Mr. Lavelle and Mr. McDermott that the pact be re-opened and amended to include separate safeguard provisions for Canadian parts production similar to those in place for assembly of vehicles. It also heard Mr. Eberle's proposal that the agreement should be expanded to include aftermarket parts and trucks and buses and, later, used vehicles. He suggested the Canadian "value added" requirements should be changed and put in terms of a running average instead of an annual basis and that there should be some mechanism to discuss grievances, government to government and industry to industry.

The Committee does not recommend the re-opening of the Automotive Agreement. Until very recently the United States has been pressing for removal of certain "value added" commitments on Canadian manufacturers which it considers transitional and Canada considers permanent. In view of the large Canadian balance of payments deficit, this issue is not being pressed at present. However, since the United States is prepared to let market forces determine the North American production pattern in this industry, there is every risk that in a renegotiation, the United States would not agree to continued safeguards for the vehicle producers, let alone for the parts producers. Moreover, the United States would be likely to emphasize the Canadian surplus in finished vehicles.

It is not widely realized in Canada that in the United States there is a more sceptical and critical perception of the agreement than in Canada. The U.S.

International Trade Commission stated cryptically in its 1976 report to Congress that

"The agreement as implemented by Canada is not a free-trade agreement, and it has primarily benefitted the Canadian economy." (page 43)

and more bluntly

"Indeed when the agreement is examined in its totality, it is manifest that the only true concessions granted in the agreement are those granted by the government of the United States according duty-free treatment to imports of automotive products manufactured in Canada. Other than the provisions of the agreement providing for consultations between the two governments, the agreement contains no substantive concessions on the part of the Government of Canada except those that are subject to the commitments and obligations to the Government of Canada in Annex A and the letters of undertaking." (page 42)

Given such United States' attitudes as quoted above, termination would be one of the possible U.S. responses to a Canadian initiative to renegotiate. And if the agreement were terminated, many more problems would ensue for Canada than for the United States.

The only immediate answer for the parts producers predicament may be suasion on the Canadian vehicle companies by the Canadian government. The vehicle manufacturers should be pressed to locate high technology in-house parts plants in Canada and encouraged to source more of their parts in Canada including those from independents. By early 1978 the Canadian government appeared ready to embark on domestic measures aimed at stimulating the Canadian parts industry and by mid-year there were indications that vehicle manufacturers were planning new investments in Canada but were bargaining for the most lucrative location inducements. In another move to stimulate Canadian-made parts production, the Canadian government stated it would remit a portion of the 15 per cent import duty now levied against Volkswagen for its imported cars and parts. The portion remitted would be equivalent to the value of Canadian-made parts in the imported cars. Similar agreements are being sought with other offshore manufacturers.

In 1977 each country concluded a two year study of the North American automotive industry from its own point of view. In mid-1978 the Canadian government established the Reisman inquiry to examine the industry with a view to "the development of an internationally competitive Canadian automotive industry". The report is due in the fall. It is expected that general discussions between the two governments could take place in the interval. It is unlikely, however, that these discussions will encompass amendments to the pact. Canada in fact, should take the opportunity to work out a stabilizing mechanism which would reinforce the *permanence* of the general framework of the Automotive Agreement. Since Canada is the smaller market, any uncertainty about the future of the agreement affects negatively the investment decisions of the vehicle and parts companies. The location of large volume engine plants or metal stamping plants in Canada is less attractive to companies because, in the event of dissolution of the pact, their capacity would be large relative to the Canadian market and location in the United States would be far safer. It may be that those voices which are advocating renegotiation of the agreement are contributing to the uncertainties which deter investment in Canada. The Automotive Agreement must provide a stable predictable environment within which long-range investment can be planned.

The Joint Automotive Agreement Monitoring Commission

The Committee recommends the establishment of a Joint Automotive Agreement Monitoring Commission in order to provide a better method for monitoring the agreement and modifying its performance in minor ways.

The overall role of such a Joint Monitoring Commission would be to help clarify the objectives of both governments and examine their mutual compatability. It would be useful to measure the ability of the automotive industry to contribute to the attainment of these various objectives. The Auto Pact has made a considerable contribution to improved economic performance in Canada but it could be destroyed if unrealistic expectations about its potential are created.

Mr. McDermott's reaction to the suggestion for a joint monitoring body was positive.

"It should be a recommending agency . . . In essence that is what we have been advocating for some time—an agency that would monitor, that would watch and would be open to input from interested parties." (II, 26:51)

Although many aspects of the agreement are not amenable to quantitative measure, a number are, and existing quantitative measures appear inadequate. It is important that better statistical measures be developed to give a longer term viewpoint to the sudden hills and valleys in the trade figures. These temporary fluctuations are the cause of agitation for restructuring the agreement and contribute to uncertainty for the industry.

This report has already suggested that to achieve a more realistic picture of automotive trade, the balance of trade figures be disaggregated to show the balance for "value added" during assembly and a balance for exchanged parts whether or not they are embodied in assembled vehicles. It is important to note that the total balance of trade in automotive parts will not be altered by this method but the Joint Monitoring Commission will be better able to interpret the causes of the balances.

Some additional general responsibilities of the Joint Monitoring Commission would be to ensure a flow of relevant and objective information and to make a broad determination of whether or not compliance with the operative safeguards was being achieved. Under directive from the two governments such a Joint Monitoring Commission would undertake impartial analysis of particular issues.

In addition, there are several particular issues which the Joint Monitoring Commission should monitor. Price differentials is one. Mr. Bennett considered that a 4 per cent differential was required in the price of cars in Canada and the United States to meet the higher Canadian costs in advertising, marketing and distribution. The Joint Monitoring Commission should assess the validity of this cost gap and provide some surveillance that the prices in the two countries do not differ, on a regional basis, by more than that difference. If higher price differentials persist, the Canadian government has a number of possible policy options available. Either the Canadian external tariff on automobiles could be lowered from its present level of 15 per cent to a level equal to the cost differences or the Canadian government grant the right to duty free entry at the retail level from the United States.

Under the present arrangements when Canada has a deficit with the United States, the Canadian external tariff protects U.S. production. If a large U.S. car is priced at 10 per cent higher in Canada than in the United States, that difference accrues to the car producer. If a French car is priced 15 per cent higher in Canada than in France because of the tariff the difference accrues to the government as revenue. The Canadian external tariff on automobiles is substantially higher than that of the United States. If automobile prices in Canada remain higher vis-a-vis U.S. prices than the identifiable and justifiable cost differentials, the Canadian government should consider a unilateral tariff reduction or, preferably, inclusion of an automobile tariff reduction as part of its concessions in the Tokyo Round of GATT negotiations.

There is, of course, no particular reason why Canada should attempt to achieve a zero balance in its balance of trade on automotive products any more than it should for minerals, agricultural trade or forest products. However, there is strong evidence that the volatility of the trade account balance in automotive products has been increased by the post 1965 rationalization of the industry. The balance has become more sensitive to the relative popularity of different models and the relative strength of total demand for automobiles in the two countries. Because of this increased volatility of the automotive trade balance, changes in the balance during one year must be interpreted carefully to avoid short-term policy decisions. Longer term averages of the balance ought to be published at the same time as the annual figures and the Joint Monitoring Commission should provide an interpretation of trends during the year.

There is another aspect of the balance of payments where the Joint Monitoring Commission might be useful. The balance of trade in automotive products reflects only a part of the foreign account impact of the automotive industry. In addition to such merchandise transactions, important transactions in invisibles also occur. A detailed listing of "other service payments" for 1973 was provided by Mr. Bower Carty of Statistics Canada in his testimony before the Committee. In that list, \$117 million payment for "special tooling and other automotive charges" is identified for that year. As has been noted, the research and development charges paid to the parent company by Canadian subsidiaries of the motor vehicle manufacturers averaged approximately \$230 million dollars during the past five years. The Committee was unable to obtain estimates of the management fees and interest payments paid by motor vehicle manufacturers or parts manufacturers to American parent companies. A complete listing of dividends paid to foreign parents is also not available. However, the International Trade Commission in the United States estimated that the average annual inflow of dividends to the U.S. "Big Four" from Canadian operators was \$114.1 million during 1973 and 1974. The Joint Monitoring Commission should obtain the information necessary to publish the automotive balance of payments between Canada and the United States for both merchandise and invisible accounts. It is clear that the overall balance of payments deficit for the automotive industry is over a half billion dollars greater than the frequently reported balance of trade.

There were suggestions by witnesses that the Canadian parts manufacturers should be protected against the flow of off-shore parts which is an additional factor

in eroding their market. As mentioned earlier, Canada allows the importation of parts on a multilateral basis (as distinct from the United States which allows them to come in free only from Canada). If these parts are assembled into a car in Canada which has at least 50 per cent North American content, the car can then be shipped into the United States duty free. Mr. John Moller of the U.S. Motor Vehicle Manufacturers Association told the Committee that the U.S. Auto Workers Union had recommended to the U.S. International Trade Commission that the 50 per cent North American content requirement be raised to 75 per cent. The effect would be to limit the incentive to assemble vehicles in Canada that contained duty free components imported into Canada from third countries.

Data presented to the Committee, however, indicated that the total of such imports remained small and there does not appear to be a strong trend developing. Some of the growth of imports from developing countries such as Brazil represents a deflection from other offshore suppliers (Germany in the case of Pinto engines) and not a diversion from a North American source. However, this question too could be examined and watched by the Joint Monitoring Commission.

The Publication of an Annual Report

In addition to the establishment of the Joint Monitoring Commission, the Committee recommends that an annual report on the operations of the Automotive Agreement be published by the responsible department and submitted to Parliament. In the United States such a report is required to be submitted to Congress annually. There have been complaints by the labour unions and the parts producers in Canada concerning the secrecy of certain operations of the agreement. Both Mr. McDermott and Mr. Lavelle favoured annual publication, Mr. McDermott stating that such a report should be based on reports required from industry. Referring to the Government's 1977 task force study in the automotive industry, Mr. McDermott said:

"We think it is a little bit amazing that the first comprehensive published review of the Auto Pact had to wait until the 12th year of operation here, because in the U.S. there is an annual report published and there is more public monitoring of what is going on. In the light of the present problems and the even more threatening future problems, we think that a regular annual public review should be instituted." (II, 26:12)

VII FUTURE DIRECTIONS AND CONCLUSIONS

This study, which began as a review of Canadian trade policy with the United States, has led the Committee to examine most elements of Canadian industrial policy. It confirms that in recent years Canadian industry has lost grounds competitively to the United States. But as has been pointed out, the United States has itself declined in relation to several other industrialized nations. In short, Canada has fallen behind the United States, while it in turn has for two decades been steadily losing ground to other industrial nations. This is a dangerous development which Canadians must face up to if they are to take effective corrective action.

The report has demonstrated that the problem does not lie in the resource sector. Reduced tax levels and the depreciation of the dollar can restore Canada's competitiveness in resource production. The problem lies in the area of manufacturing. Its most disturbing symptom has been the shift of manufacturing capacity from Canada to the United States, the result of declining competitiveness and reduced tariff protection. This is a development which, if unchecked, can only lead to the eventual de-industrialization of Canada. But while lower tariffs have intensified the problem, for reasons to be elaborated later in this chapter, the Committee does not regard higher tariffs as offering a solution. What is needed is an increase in Canada's competitive capability.

The decline in competitiveness came about with surprising speed, the result of a national misjudging of our economic prospects. The combination of a favourable turn in the terms of trade in the early 1970s caused by a strong market for Canadian resources plus an over-estimate of Canada's oil reserves (which was not corrected until 1973) contributed to an exaggerated sense of Canada's economic potential. The sentiment was well expressed in the official policy paper on the "Third Option", which was published in the autumn of 1972.

"Our trading position is strong. We are regarded as a stable and affluent country with a significant market and much to offer to our global customers in the way of resources and other products. Our balance of payments has been improving in relative terms. We are no longer as dependent on large capital inflows as we once were."

Canadians responded to their good fortune by cashing in the benefits. While the United States underwent a sharp depression between 1973 and 1976 with actual declines in real hourly earnings, Canadians' real wages surged ahead. Basing itself on a miscalculation—that the 1973 downturn would be short—the federal government encouraged Canadians in their mistaken self-confidence by suggesting that Canada's economic situation and performance were superior to those of the United States. To support demand it increased the money supply and both senior levels of government borrowed heavily in the United States and elsewhere. The extent of the national binge is shown by the movement of real hourly earnings in Canada and the United States. Between 1970 and 1976, while U.S. real hourly earnings grew from

100 to 105.3 per cent, the growth in Canada was from 100 to 125.8 per cent (Annex A, table 1)

One consequence of living next to the United States is that Canadians have a ready-at-hand standard of comparison by which they can judge their economic performance. Having similar working practices, tastes and currencies which carry the same names for the units of measurement, comparisons are simple and instinctive. This situation has its advantages but it also has disadvantages.

Until the 1960s most Canadians accepted that their wage and salary rates would be at least marginally lower than those in the United States. With the signing of the Auto Pact this general perception was breached. Not surprisingly, the United Auto Workers in Canada set their eyes on wage parity, arguing that as the auto companies moved toward comparable rates of productivity in Canada with that of the United States, the workers in the industry should share in the benefits. Had other Canadian wage rate increases been strictly related to productivity increases, no great problem would have occurred. But, stimulated by the buoyant economic conditions of the early 1970s, workers in industries other than the auto industry, and especially in the public sector, began pressing for wage increases to match the auto workers, even where there were no comparable productivity gains. Their efforts were successful and as a result unit labour costs in Canada got out of alignment with those in the United States.

In the past year the situation has stabilized and even shown improvement. Wage rate settlements are comparable to those in the United States and, given the current economic situation, are not showing signs of rising disproportionately following removal of the AIB. The exchange rate depreciation represents an important adjustment. In 1977 unit labour costs expressed in terms of U.S. dollars actually fell by 2 per cent.

This benefit from the exchange rate depreciation is a one-time gain. Moreover, it will only be effective as long as salary and wage increases do not attempt to recoup the actual fall in Canadian living standards which the exchange rate decline reflects. Even such restraint will not be sufficient to regain fully the lost competitiveness. This will require that unit labour costs increase at a slower rate than in the United States. And since productivity gains will at best come slowly, this must mean that wage rates in Canada should rise a little slower than those in the United States. This is not a prescription which Canadian trade union leaders can be expected to accept unless Canadian business leaders for their part exercise restraint in their salary increases and are prepared to make their contribution to strengthened Canadian competitiveness by investing profits in new equipment and generally improving the efficiency of their plants. Wage restraint can only be accepted if there is a national awareness of the seriousness of Canada's economic perspective and general agreement on the actions which all must take to improve the nation's competitive capacity.

An important conclusion of the Committee's study is that government policy changes alone will not solve Canada's problems. Such an approach is misleading since it removes from the citizen a sense of personal responsibility for the situation in which he finds himself. It is important to note that other industrialized countries have developed that critical ingredient—a consensus between government, business

and labour—which enables the leading elements in the society to work in relative harmony. Those which have succeeded—notably West Germany, Switzerland and Japan—have done so because their populations have concerted their actions, recognizing that the greatest gains come through working together.

It is important that Canadians recognize that the world economy is facing the most serious difficulties of the post war era. The period of rapid increases in living standards is over, at least for the present, and all countries are experiencing high levels of unemployment. In such a situation, each country and each government is scrambling to protect jobs by trying to hold on to its domestic market, while maintaining and expanding exports by every conceivable device. Protectionist measures are being introduced in all industrial countries and each move begets a response despite the high-principled rhetoric at GATT.

Canada lacks natural economic defences; its domestic market is small and it has a high dependency on foreign trade. At a time when many countries are joining trade blocs to achieve access to a market of at least 100,000,000 people, Canada is “odd man out”. Its efforts during the decade to pursue the “Third Option” and to expand its economic links with the European Community and Japan have not succeeded. Since 1973 the proportion of Canadian exports to the United States has not fallen below 65 percent, while shipments to the European Community and Japan have amounted to only about 11 percent and 6 percent respectively, with the remaining 18 percent divided among all other countries. Indeed, the most recent quarterly figures show a higher proportion of Canadian exports going to the United States (72.4 percent for the first quarter of 1978) than in any previous quarter. In a period of protectionism, it is surely self-evident that Canada’s overriding concern must be to enhance its competitiveness and its access to its principal markets, namely the United States.

1. Multilateral Trade Negotiations

The choices which Canada and Canadians face, as the country attempts to recover its competitive position, would be difficult in almost any circumstance. The coincidence of the final stages of the Multilateral Trade Negotiations (MTN) under the GATT, known as the Tokyo Round, adds a new complication and increases the uncertainties. Canada’s stake in these negotiations is high. The tariff and non-tariff arrangements which may be agreed to during the 1978 negotiating sessions could mold Canadian trading patterns and the viability and development of Canadian industry during the 1980s and 1990s.

By early 1978 the objective for tariff reductions agreed among the major negotiators at Geneva stood at an average across-the-board 30 to 40 percent reduction, the so-called Swiss formula. Canada’s average tariff level on goods which are dutiable is higher than any of its major trading partners. The proposal is that cuts would be proportionately greater on higher tariffs than on lower tariffs. Thus Canada would lose more in respect to its protected manufacturing industries than it would gain through improved access for the export of its resource-based products. As it is, some Canadian industries are having trouble competing with imports even with

the existing levels of protection. With the tariff substantially lower, a significant number of companies in Canada would have great difficulty withstanding the pressure of products from the new, low-wage, growth centres such as Hong Kong, Brazil, Taiwan or South Korea, let alone from the United States, Europe and Japan where existing scale and specialization give them an established edge. The nearby U.S. secondary manufacturing industry is in a position to take advantage of this opening-up of markets whereas much of Canadian industry is geared mainly to the small domestic market. There is little doubt that a 30 to 40 percent tariff reduction would be a devastating blow for some Canadian companies. Others would face enormous challenges and be required to make major adjustments.

As the negotiations reach the critical stage, business and trade union leaders in Canada are expressing deep concern over the possible effect of tariff reductions for the industries with which they are associated and are questioning the government's announced policy favouring tariff liberalization. But can Canada prudently reject the Geneva goals? If Canada retained or increased its present tariff barriers when other participating countries had lowered theirs, it would face retaliation from its trading partners, including the United States. Canadian consumers would pay more for imported products and Canadian manufactured exports would meet new difficulties in penetrating even traditional markets.

In a protected environment the technical competence of Canadian industry would diminish farther, isolated as it would be from the necessity of competitive performance. With little import competition, incentives for better productivity rates, superior technology or increased efficiency would be lacking. Although some segments of Canadian industry might feel greater certainty behind a protective barrier, the Canadian standard of living would decline with Canadians facing higher prices, reduced incomes and a restricted choice of goods. Such a course would be costly and harmful to Canada.

The Committee concludes that Canada as a major trading nation has no alternative to participating in the GATT negotiations and to making the best deal possible. The failure of the multilateral trade negotiations could adversely affect the level of world trade and Canada, as a major trader and supplier of commodities, would be one of the first to suffer.

On the other hand, if the GATT negotiations were successful, non-tariff barriers would assume a proportionately greater significance in international trade. Having depended heavily on tariffs to protect domestic industry, Canada has relied less than most industrialized countries on limiting imports by means of non-tariff measures. Past experience with other countries' NTBs should lead Canadians to be sceptical that they can be policed effectively on a multilateral basis even if the MTN succeeds in evolving international codes of behaviour to try to standardize and regulate them. Surveillance would be difficult. To deter violation of the codes, tough hard-to-achieve sanctions would be required.

Nevertheless, the Committee supports the government's insistence on linking across-the-board tariff reductions with solid progress in lowering the barriers constituted by non-tariff measures; otherwise Canada would be giving up more than it gained.

2. Alternative Policies

It is against this background that the report reviews the major trading options which Canada now faces:

- a) modified tariff protection with a program of domestic remedies,
- b) sectoral free trade arrangements with the United States,
- c) multilateral free trade or unilateral free trade,
- d) bilateral free trade with the United States.

a) Modified Tariff Protection with a Program of Domestic Remedies

This report has already examined various proposals for strengthening Canadian industry through domestic action (Chapter IV). Specifically it has looked at programs designed to encourage industrial rationalization, to promote R & D, to support the manufacture of promising products through government procurement and to assist exporters by remitting duties on imported components intended for re-export. The Committee has made recommendations in these areas:

- that competition policy be modified to provide a conducive climate for the rationalization of Canadian manufacturing production and that the government offer some inducements to rationalization.
- that the Department of Finance consider the possibility of offering a Duty Remission Program to individual Canadian machinery equipment producers for particular lines of machinery in which they might seek to specialize.
- that, to encourage increased R & D in Canada, it may be necessary to offer even greater tax incentives than those announced in October 1977 and in the April 1978 budget.
- that the federal government seek, in selected fields of particular Canadian competence, to coordinate its purchasing decisions and those of provincial departments, local governments and crown corporations.

In each instance, the Committee has assessed the limits of what might be achieved by such measures. It is already more than a decade since the attempt was last begun to revise competition policy. Speedy action is therefore unlikely, and the results at best would be felt slowly. A Duty Remission Program for the machinery industry, while it might promote some rationalization, would likely have only a marginal impact, and it would be most effective only as an interim measure. Increased R & D in Canada, even if it can be stimulated, will produce results only in the longer term. Finally, the Committee has found that there was, practically speaking, not much margin for increasing procurement in Canada by the federal government and so many obstacles to the effective coordination of provincial procurement with that of the federal government that the benefits would at best be limited. In sum, the Committee concluded that even the most vigorous application of these policies would have comparatively little effect on the competitive position of Canadian industry.

b) Sectoral Free Trade Arrangements with the United States.

A remedy which has received support in recent years is a form of sectoral free trade, sometimes proposed in a multilateral form, but more frequently bilaterally with the United States. The Automotive Agreement stands as an instance of limited free trade between Canada and the United States in a particular industry. Trade under the Defence Production Sharing arrangement is another example. The question is, can this pattern be extended to other industries?

In both these cases, the Canadian objective in negotiating the arrangement was the strengthening of the industries involved through providing opportunities for economies of scale — exactly what is needed in so many Canadian industries. In both cases, negotiations succeeded in gaining free access to the U.S. market for Canadian producers of a number of highly processed goods. In both cases certain safeguarding mechanisms were put in place; in the Auto Pact minimum production levels were safeguarded for the Canadian producer and in the defence production area the 1963 “understanding” provided for “a rough balance” of trade.

U.S. objectives in these arrangements, it is important to note, were not exclusively economic. The United States agreed to the Defence Production Sharing arrangement largely as a gesture of continental defence solidarity, after the failure of the Arrow project made it clear that Canada would have to look abroad for all major military procurement. In the case of the Auto Pact, U.S. motives were more strictly economic; rationalization offered some benefits to the United States as well as Canada. But the U.S. government was also anxious, for political reasons, to avoid the kind of trade war which the Canadian duty remission scheme on car exports threatened to precipitate. Despite the undeniable benefits which the Auto Pact has bestowed, it must be recognized that it has also aroused considerable criticism and debate on both side during the 13-year period of its existence. Periodically there have been strong pressures for change and even, on the U.S. side, for termination of the agreement.

The automotive industry has some unique characteristics which facilitated the development of a bilateral free trade arrangement. Mr. Roy Bennett of the Ford Motor Company of Canada told the Committee that few other industries have the same very small number of companies and the clearly identifiable product which made it easy to establish guidelines in the automotive sector. He might have added that the parent-subsidiary relationship in the industry across the border was also an asset, perhaps an indispensable one, in the structuring of the agreement. A common international union in plants on both sides was undoubtedly helpful, as was the concentration of Canadian and U.S. production facilities in fairly contiguous regions.

The defence industries of the two countries have very different characteristics—an enormous range of firms, both large and small, some national, others multinational, producing a virtually limitless range of products from clothing to items of the highest technology. The factor which homogenizes the industry and makes the Defence Production Sharing arrangement possible is that there is a single buyer in each country, the respective defence departments. This is an element which makes it possible for the two governments to maintain a “rough balance” in their defence trade.

In looking at other possible areas for sectoral free trade, a difficult problem is the delineation of which dependent or associated industries should be encompassed in any such agreement. GATT objections to an exclusive bilateral trading concession could also present a problem. However, as the United States overcame this latter difficulty at the time of the Automotive Agreement by obtaining a waiver, presumably similar exemptions could be obtained again, even though the two countries would not, strictly speaking, be participating in a regional free trade arrangement as permitted under GATT.

A major hurdle in applying the sectoral free trade formula to another industry, however, would be the problem of safeguards. Unless there were full bilateral free trade, in which case the exchange rate would become the principal equilibrating mechanism, Canadian safeguards would be a prerequisite to any new sectoral free trade arrangement. Because of superior size and strength and certain built-in advantages on the United States side, specific guarantees would be essential to ensure the Canadian industry a proportionate share of production. This may be needed particularly to protect Canadian branch plants from either overzealous rationalization or a phasing out of Canadian operations by the U.S. parent company or from possible policy initiatives of the U.S. government in the field of repatriation of foreign investment or returns. The United States might want similar safeguards in respect to Canadian multinationals operating in the United States.

The president of Ford (Canada) told the Committee that it would be "dangerous" for Canada if there were totally free access to the Canadian market from the United States in automotive products, and he agreed that safeguards were required to maintain the Canadian production share. In non-production areas such as advertising, marketing and distribution, he explained, there is an additional cost amounting to about 3 to 4 per cent of doing business in Canada as compared to the United States.

It is noteworthy that while these automotive safeguards appear fundamental to Canada, the U.S. government contends that the safeguards were meant to be transitional. It apparently continues to argue thus, even though it has had a favourable automotive trade balance for several years and a cumulative balance of \$7 billion over the first 13 years of the pact. The United States' position is that it is prepared to accept whatever trade pattern results from a completely free market operation of the agreement unimpeded by safeguards. Hence Canada has resisted pressure to remove the production safeguards, the more so since in recent years it has had a substantial trade deficit position in automotive products. In fact, these deficits have caused Canada to look for an *extension* of safeguards to protect and expand its automotive parts industry.

The stalemate in the automotive sector over safeguards can only serve as a warning of the difficulties which could be expected in any other sector. This will be particularly so in arriving at an agreed definition of how to assess the benefits and costs of an agreement to each country and how to ensure a fair sharing of the total market by both sides without putting too many constraints on the free working of the market place. For Canada, therefore, the question is whether the United States is likely to agree to production safeguards satisfactory to Canada in a free trade

arrangement in any other industrial sector. At this moment, it seems doubtful. Even recognizing the fact that specific safeguarding details would vary, depending on the industry selected, the basic goal for Canada would remain the same—to maintain a fair and equitable share of production. If the United States were to agree on safeguards initially, it seems likely that it would insist on their transitional nature, with a clearly enunciated cut-off date. Or alternatively, the United States might write a mechanism into the agreement for amending or revising the agreement as conditions warrant. This would expose Canada to bargaining from a very vulnerable position.

No attempt has been made here to assess the industries which might be most suited to such initiatives, but from time to time academic and other studies have mentioned the chemical industry, the computer industry, the major appliance industry, the non-ferrous metals industry, the specialty steel industry and the forest industry as possible candidates. While a number of these industries possess some of the characteristics described above and would clearly benefit from economies of scale, it is difficult to find one which could risk the plunge into bilateral free trade without fairly specific production safeguards. These, in the light of the Auto Pact experience, the United States seems unlikely to grant.

In any case, it is far from clear how the United States would react to an initiative to sectoral free trade arrangements with Canada. While the U.S. Trade Act of 1974 included a provision authorizing the Administration to negotiate a bilateral free trade agreement with Canada, limited sectoral arrangements do not offer the United States attractive benefits. Nor are there obvious non-economic factors of the kind which influenced the United States' decision to agree to the two existing sectoral free trade arrangements.

U.S. attitudes might be quite different, however, if sectoral free trade arrangements were to be proposed as transitional steps toward complete bilateral free trade. This would put the issue in a larger context and could prove to be more acceptable in the United States.

Mr. William Eberle, a former senior U.S. trade official told the Committee that he thought it was time that Canada and the United States worked toward common solutions in certain industrial areas by means of joint fact-finding groups or commissions which would include industry and labour and senior government officials. While Mr. Eberle did not specifically link this suggestion with sectoral free trade arrangements, elsewhere in his testimony he expressed the opinion that the chemical industry and the forest products industry might be potential areas for the application of an Auto Pact type of arrangement. This suggestion of joint fact-finding commissions appears to be an effective way to examine the problems, if it were decided to move in this direction.

c) Multilateral Free Trade or Unilateral Free Trade

The argument in the Economic Council's report "Looking Outward" in favour of multilateral free trade is prefaced by an emphasis on the undeniably important fact that Canada and Australia are the only industrialized countries without free access to a market of 100 or 200 million people and that scale and specialization in

industry is of critical importance in cost competitiveness and technological innovativeness. With tariffs eliminated, that report argued, companies would be forced to rationalize their production in order to compete internationally. Lower unit costs would be realized through product specialization and economies of scale.

It is evident that in general the present high levels of tariffs are proving to be self-defeating for Canadian secondary manufacturing. The tariff combined with foreign ownership—which is itself a product of earlier tariff policy—has produced or maintained a basically inefficient industrial structure with truncated branch plants producing too large a range of goods with too short production runs for too small a market. Nor has the high tariff actually been able to protect many of these industries once their competitiveness had slipped.

Yet in the contemporary economic situation, multilateral free trade is not a realistic prospect. No country is advocating it. Despite their support of trade liberalization in the Geneva talks, many industrialized countries are actually taking protective measures when vital products such as steel are threatened. In the present international climate it is difficult to treat the idea very seriously.

Nor should Canada under any circumstances consider offering free entry unilaterally as mentioned as another possibility by the Council. Such a course would unfairly expose Canadian industry to a flood of imports from foreign, including U.S., industries, which benefit from the production efficiencies obtainable in large markets. At the same time, Canada would be giving away, with no return, all its bargaining chips.

d) Bilateral Free Trade with the United States

Using much the same argument as it used in favour of multilateral free trade, the Economic Council's report "Looking Outward" espoused a Canada-United States free trade arrangement as "the only other option offering economic benefits roughly commensurate with the gains that would accrue from multisided free trade". This option was the one the Committee examined most closely as a possible course for Canada.

The Committee's evidence relating to this issue was taken principally during the year 1976, at a time when Canadian wage rates were rising faster than those in the United States, when days lost through strikes were unusually high and when the Canadian dollar was above par. In these circumstances it was hardly surprising that most comments by Canadian businessmen reflected either a negative or a cautionary note on the bilateral free trade proposition. While this support for tariff protection was predictable, it is important to identify the variety of their reasons against free trade with the United States.

Mr. Walter Ward of Canadian General Electric acknowledged that Canada needed the discipline of international competition to maintain competitive industries, but he advocated only a reduction of tariffs rather than elimination, and then on a very selective basis, "to be sure we keep competitive pressure on Canadian industry". (I, 38:12) Mr. Bruce Sully of Dominion Road Machinery maintained that Canada

must have tariff protection because of inequalities in the cost of money, the rate of inflation and the lack of economies of scale in Canada. Canadian multinational manufacturing companies such as ATCO warned that if Canadian tariffs were eliminated, their companies would be better off exporting back into Canada from their U.S.-based plants instead of manufacturing in Canada. While the Chemical Producers Association favoured trade liberalization and selective tariff reductions for its industry, they considered that some form of protection was necessary for certain of their products which provided an essential link between the resources industries on one hand and a very wide spectrum of industrial and manufacturing activities on the other. Mr. A. J. Foote, Chairman of the Association, thought "Canada would be at a serious disadvantage in a free trade environment" because of its lower labour productivity, higher construction costs, higher financing charges and climatic factors.

"It is our view that the Canadian tariff should be high enough but no higher than what is required to offset these cost penalties for operating in Canada which are virtually beyond our control." (II, 11:12, 13)

Mr. McCarthy of Du Pont of Canada judged that free trade would result in a tendency to locate new facilities in the United States in order to be nearer the centre of the market and predicted it would mean an "inevitable slow death" to the company in Canada. (II, 11:50) Mr. R. W. Chorlton of Wajax asserted that any further reduction in the tariff on machinery would lead to a slowing down and eventual closing of many U.S.-owned machinery plants in Canada.

Mr. William Mounfield of Massey-Ferguson was one of the few manufacturers who spoke positively of bilateral free trade. As far as his Canadian farm machinery company was concerned, it had benefitted from the essentially free trade atmosphere. He attached importance to the early start and strong position of the company historically in Canada and cited the acquisition of a U.S. tractor company as a factor in Massey-Ferguson's successful operation in the free trade environment. Mr. Mounfield warned, however, that the same situation would not necessarily apply to other Canadian industries; each one would have to be examined individually to assess its capacity to compete in the North American setting. Even the Canadian steel industry which is generally considered to be among the most competitive in the world was cautious. Stelco's president, Mr. J. D. Allan, said that for a number of reasons related to population and geography, bilateral free trade would give greater advantage to the U.S. industry than to the Canadian industry. Mr. A. V. Ohlson of Atlas Steels said that while his company, a maker of specialty steel, would welcome bilateral free trade with the easier access to the U.S. market, much would depend on whether their Canadian customers could survive competitively in such a situation. If not, the market would tend to move south of the border, leaving Atlas less freight competitive.

Two major national organizations were concerned about the timeliness of moving toward free trade. In addition to its concern that Canada might not get its share of the action in a free trade situation with the United States, the Canadian Manufacturers Association felt that Canadian industry had to get its "house in order" before it could contemplate such a move. (II, 4:57, 80) The Canadian Importers Association considered that the benefits of free trade would be enormous,

but judged that the Canadian manufacturing industry was "unready" for it at the present time. (II, 1:42)

Benefits and Risks

The Committee's problem is to judge how much the depreciation of the Canadian dollar, the improvement in the ratio of time lost through strikes and the moderation of wage settlements will have affected the perspective of Canadian producers and manufacturers. Mr. Robert Scrivener of Northern Telecom asserted when he appeared before the Committee that tariff-free access could result in his company supplying the Canadian market from the United States. However, his warning was linked to the hypothesis that high Canadian labour rates and other unfavourable factors related to competitiveness would persist. These conditions have now improved. In particular, the dollar depreciation has largely compensated for the relative growth of Canadian wage rates during this decade. And Mr. Scrivener, in a speech in March 1978 to the Ontario Economic Council, twice urged Canadians to "start thinking of a *North American alliance* as the prime position for our national industrial objectives and strategies . . . to prepare ourselves for the onset of the international and intercontinental trade battles of the Eighties." (italics added). While the formulation is ambiguous, it sounds like an appeal to Canadians to think seriously about some form of bilateral trade arrangement with the United States.

Under bilateral free trade, U.S. tariffs would be removed providing easier access for Canadian exports. The protection now afforded domestic industry by specific Canadian tariffs would be replaced by a general protection provided by a depreciated dollar. Unlike the tariff, however, the benefit would be two-fold; apart from a discouragement to imports equivalent to a tariff, a depreciated currency also offers an advantage akin to a subsidy to exports. So a devalued dollar would compensate for some of the inescapable higher costs of doing business in Canada.

The critical question is whether companies would make investment decisions on the assumption that the Canadian dollar under bilateral free trade would remain devalued. The experience of recent years when large capital borrowings sustained the dollar above par would be reason for scepticism. However, with tariff protection against U.S. imports removed, to the extent that Canadian manufacturing was not competitive, there would be downward pressure on the Canadian dollar. The exchange rate would adjust to reflect the relative competitive conditions in the two countries.

A move toward bilateral free trade with the United States would, of course, significantly change the competitive position of many industries. Some Canadian industries would be placed in a strong competitive position; others would suffer a sharp decline in output and employment. Even with a movement toward free trade phased in over a number of years, the temporary dislocation would be considerable and a major program of industrial assistance would be needed.

The regional impact would of course vary. It has been argued for a hundred years that protectionism has weakened the Maritimes, inhibited growth in the West and unfairly strengthened central Canada. While the western and Atlantic provinces would benefit from having access to lower cost manufactured goods and the opportunity to process their natural produce to higher levels, many smaller producers

in those areas would suffer from the stronger, cross-border U.S. competition. The initial dislocation to Ontario and Quebec could be difficult and certainly some industries would be forced to close. But the Economic Council has suggested that the gains from free trade for Ontario and Quebec might eventually be greater than the Maritimes or the western provinces since, in any rationalization, it is likely that plants closer to the major domestic market would be the ones chosen by industry to adapt to larger scale and more specialized production.

There is reason to believe that certain industries, including textiles, would be in an improved position operating within the large Canada-U.S. market with continued tariff protection against low-cost third country producers.

The peculiar characteristics of branch plants in Canada of U.S. multinationals add an additional uncertainty. How would they react in a free trade situation? The optimum would be if companies were to opt for specialization on a North American basis with the Canadian plants supplying particular products to the combined market of the two countries. However, there are a number of factors—over-capacity in U.S. plants in low periods of the business cycle, the pull of the larger, i.e. U.S. market, a perceived change in the reliability or stability of the Canadian political base and a natural tendency to reinvest at home rather than in a foreign jurisdiction—all of which might cause repatriation of production to the United States. This is the most serious risk of bilateral free trade. In responding to a question on general free trade, Mr. Walter Ward of CGE pointed to the danger that

“To invest in a plant in Canada whose output . . . would be up to 90 per cent dependent on free access to the U.S.A. or other markets would or could possibly be providing hostages to a whole range of factors affecting our relationship with those countries”. (I, 38:11)

Multinational companies, no matter where their headquarters are located, seek the best rate of return. Providing that costs of production, adjusted by the prevailing rate of exchange, are lower than those of the United States, companies will have an incentive under free trade to locate production facilities in Canada and even to supply northern parts of the United States from them.

Mr. Ward's response raises the question whether a company making a decision to invest in the smaller country assumes a risk that the export of its product to the larger market might be blocked by a non-tariff barrier (NTB). This concern points to a potential benefit from bilateral free trade on which none of the witnesses focussed—a possible resolution of the problem of non-tariff barriers. This report has stressed that NTBs in general are likely to dislocate trade in a period of reduced tariff protection even if the GATT negotiations agree on the means of monitoring them. In addition, it has considered a series of non-tariff measures which now limit trade between Canada and the United States and has drawn attention to new obstacles being proposed to protect U.S. industry which would further inhibit the export of Canadian manufactured goods to the United States.

One of the principal advantages of a free trade agreement is that it provides an opportunity for negotiating mutual exemptions to the provisions of non-tariff protec-

tive measures. While there are certain limitations to achieving a complete absence of non-tariff measures, the free trade agreements negotiated by individual European states such as Sweden and Finland with the European Community illustrate the potential of such a negotiation. If Canada were to propose to the United States that the two countries form a bilateral free trade area, it would be essential to include as part of the negotiations mutual exemption from the provisions of U.S. non-tariff protective measures. Two examples will illustrate the potential of this approach. The zinc producers of the United States appealed to the International Trade Commission for a high tariff on refined zinc imports beyond a specified volume. The U.S. industry acknowledges that they are seeking protection against European custom smelters which are dumping surplus production rather than against Canadian producers which have always sold fairly at the New York price, no matter how tight supplies were. The copper producers are also seeking protection by means of a quota on imports. Under GATT rules Canada could be exempted from such U.S. devices if it formed part of a regional free trade area.

The success of the Defence Production Sharing arrangement derives from the exemption of Canada from the provisions of the Buy American Act. Under a bilateral free trade arrangement, Canadian companies should be free to quote on all U.S. federal government procurement and vice versa of course. Even existing limitations such as the specialty steels reservation on defence contracts would be opened up for Canadian bidding. Providing therefore that Canada was exempted from the major U.S. non-tariff barriers, the benefits to Canada from bilateral free trade would be much greater than they are generally perceived. If each member country exempted the other from its NTBs and there was truly a North American market, companies could then decide to invest on the basis of the relative costs of production as adjusted by the rate of exchange.

3. Conclusion

Starting from the perception that serious measures have to be taken to improve Canada's competitive capacity, the Committee has considered each of Canada's principal options.

- It rejects increased protection as leading inevitably to diminished competitiveness and a declining standard of living.
- It supports general tariff reductions under the GATT, on condition that non-tariff measures are equally and effectively dismantled, but is sceptical regarding the effectiveness of the results expected to emerge from the multilateral trade talks.
- It makes recommendations for strengthening the competitive capacity of Canadian industry, but concludes that these measures by themselves are insufficient to achieve the rationalization needed by Canadian manufacturing.
- It sees no prospect for general free trade and counsels strongly against any suggestion of moving toward unilateral free trade. The preferred arrangement for Canada would be to negotiate sectoral free trade arrangements with the United States where there would be a benefit to Canada in doing so, but it is

unlikely that such an approach would be of interest to the United States unless it were as a first step toward bilateral free trade.

It was against this background that the Committee has concluded that, in order to resist the gradual shift of Canadian manufacturing capacity to the United States and to strengthen potentially competitive firms and industries in Canada, Canadians should seriously examine the benefits to be derived from free trade with the United States. It is not a policy without risk, but the Committee is convinced that the balance of advantage from bilateral free trade with the United States is greater than most witnesses perceived for the following reasons:

a) An exchange rate differential can provide a more general and efficient protection than the tariff, one which also encourages adjustment to changing economic conditions and opportunities. The 15 per cent depreciation of the Canadian dollar vis-à-vis the U.S. dollar in the past two years represents a greater measure of protection than most Canadian tariffs now offer and in addition provides a form of subsidy to Canadian exports to the United States larger than most U.S. tariffs now in place.

b) Without unimpeded access to the United States market, it will be difficult — even with government encouragement — to rationalize industrial production and for Canada to become more competitive. As tariffs decline, the pressure from abroad, including the United States, for more effective non-tariff barriers may grow and Canada may find itself increasingly squeezed out of the U.S. market. Only a blanket exemption for Canada, which should be negotiated as part of a free trade arrangement, could avoid this risk, and reverse the trend for U.S. companies to close their Canadian subsidiaries and for Canadian companies to move southward.

c) It used to be argued that bilateral free trade would be risky because it would encourage labour in Canada to seek parity with U.S. workers. However average wage rates in Canada have in the last few years grown to the point where they equal or exceed those in the United States. Bilateral free trade should now be perceived as a discipline to hold Canadian wage rates in line.

d) A normal feature of all free trade arrangements is a phased implementation. A bilateral free trade agreement with the United States should be entered into in stages over a minimum of ten years. If the United States agreed to the principle of free trade with Canada, it is reasonable to expect that it would also agree to negotiate interim free trade arrangements in sectors to make the process of adjustment less difficult.

Any move toward bilateral free trade would have to be carefully prepared domestically. The political uncertainties resulting from the Quebec situation make this a difficult step to take at this moment, and the Canadian public may not be ready for a policy change of this magnitude. On the economic side the weak competitive position of the Canadian economy would result, even with extensive adjustment schemes, in serious dislocation of Canadian secondary manufacturing. But bilateral free trade with the United States appears to offer in the long run the most effective approach to overcome the economic problems which Canada is facing.

Furthermore, in geographic, economic and cultural terms the United States is the only obvious trading bloc partner for Canada.

Simultaneously, the United States appreciation of the benefits to be gained from the larger market of North America may grow. Mr. John Shepherd of the Science Council maintained that the United States was the only industrialized country which experienced a reduction in the proportion of its exports accounted for by finished manufactures in the period between 1955 and 1970. There is support in Congress for free trade with Canada; it was a Congressional initiative which led to the inclusion of the authority to negotiate a regional free trade agreement with Canada in the U.S. Trade Act of 1974. Thus, there are reasonable prospects of an interested United States response, making this a viable option.

Limited sectoral free trade would, from Canada's point of view, involve fewer risks and ensure that a market would only be opened when benefits were to be gained. But these same considerations render improbable United States interest in such arrangements, and as a minimum, the U.S. would oppose any significant safeguard provisions. Under a bilateral free trade agreement, safeguards would not be needed by Canada because movements of the exchange rates would serve as a balancing mechanism.

Bilateral free trade in North America has often been presented as heading inevitably to the economic and cultural assimilation of Canada by the United States. Only half a dozen years ago the government espoused this viewpoint when it advocated what it called the "Third Option". In discarding option number two — "Canada can move deliberately into closer integration with the United States" — the then Secretary of State for External Affairs, Mitchell Sharp, argued that the process was irreversible, leading progressively from free trade to a customs union to political union.

The Committee disagrees. Having presented reports in 1973 on the necessity of developing more intensive Canadian relations with the European Community and in 1972 on the need to expand relations with Japan, the Committee is fully aware of the importance of these extra-continental relationships. But an effort to expand these connections is not inconsistent with pursuit of the long-term goal of free trade with the United States. An economically strong Canada is in a much better situation to maintain political and cultural independence than an economically weak Canada.

The European Community was first formed in 1957 by France, Germany, Italy, Belgium, Luxembourg and the Netherlands as a common market providing for a free flow of capital, labour and goods, and for a Common Agricultural Policy and common external tariffs. In response, most of the remaining countries of Western Europe—initially the United Kingdom, Sweden, Norway, Denmark, Iceland, Portugal and Switzerland and subsequently Austria and Finland—formed a European Free Trade Area (EFTA) which involved free trade in industrial goods but none of the other characteristics of a common market or customs union. This situation continued until the United Kingdom and some other members of EFTA decided to seek membership in the European Community. The success of these negotiations effectively terminated EFTA, whereupon the remaining small countries of Europe such as Switzerland (6,000,000 inhabitants), Portugal (9,199,000 inhabitants),

Sweden (7,730,000 inhabitants), Austria (7,250,000 inhabitants), Finland (4,640,000 inhabitants) and Norway (3,723,000 inhabitants) all decided to make industrial free trade arrangements with the Community. If their populations are compared with the Community's 225,000,000, in every instance, the disproportion is substantially greater than Canada's population relationship with the United States.

Finland's case is particularly interesting. During its association with EFTA, Finland monitored its exports of industrial goods. It found that such exports expanded more rapidly with the United Kingdom under free trade, even though the U.K. then had a sluggish economy, than with Germany, whose economy was booming and which had traditionally been Finland's closest trading partner, but to which Finland did not have free access. This experience persuaded Finland to enter into a free trade agreement with the Community upon the disbanding of EFTA. Even Norway, which narrowly voted against joining the expanded Community, immediately thereupon entered into a free trade arrangement with it.

The free trade agreements entered into by these European countries with the EC have certain common characteristics which must be kept in mind when considering such an arrangement between Canada and the United States. Each involved a transitional period of 10 years or more, and left both parties free to set their own external tariffs and NTB's, all in accordance with the rules of GATT.

The European parallel might suggest that it would be wise to proceed from the first to establish a North American free trade agreement to include Mexico and the countries of Central America. The Committee disagrees. It will be difficult enough to negotiate a free trade arrangement with the United States, without further complicating the task. However, it should be understood that any agreement reached should be open to accession subsequently by third countries, just as the European common market provided for expansion.

Canadian political and economic sovereignty will be protected providing certain conditions are maintained. It has already been suggested that under free trade, exchange rates between Canada and the United States should move freely. Indeed this would be the main equilibrating mechanism between the two economies. Only a free trade arrangement is being proposed, not a customs union, so that while trade barriers for industrial commodities would be eliminated each country would remain free to set the conditions of its trade with third countries. Agricultural trade would also be excluded as was the case with the EFTA countries. Each country would continue to control the rate of development of its own resources, which would involve the right to limit exports. It would probably also be necessary for internal political reasons to work out mutually acceptable systems for assisting the less developed regions of both countries.

It has been suggested that in the short term the Quebec political situation precludes an immediate initiative. But the prospect of a free trade arrangement between Canada and the United States raises an interesting perspective. On the one hand, Quebec would have little economically to offer to Canada which had access to the entire U.S. market; on the other hand, the cost to Quebec of being outside such an arrangement would be enormous, and not only in economic terms. From the point of view of both Canada and the United States, a policy which would lead to a

strengthening of Canadian unity would be an important non-economic benefit to be derived from pursuit of the bilateral free trade objective.

The Committee recognizes that major governmental assistance to industry would be required during the transitional period, but this report has not attempted an examination of this important issue. The Committee decided that this difficulty has been successfully resolved in many other countries. There was no reason why it could not be as effectively solved in Canada as elsewhere.

No government would proceed to adopt the goal of free trade with the United States without intense internal debate and public discussion which would extend over several years. Negotiations with the United States would take some time as well, so that the earliest that an agreement could be concluded might be five years. Transitional arrangements might extend over a further 10 or 15 year period. Full bilateral free trade would therefore not be fully effective until almost the turn of the century.

The outcome of the GATT negotiations will significantly affect the context in which the recommendations in this report will be considered. Even if the negotiations are largely successful, it will still be important for Canada seriously to consider a free trade arrangement with the United States. But should negotiations collapse or produce minimal results, bilateral free trade with the United States may suddenly be the only possible solution.

The Committee is aware it is prescribing strong medicine. But just because the patient is too weak at this moment to take the full medication, it does not follow that bilateral free trade is not a desirable objective in the long term.

The Committee urges governments in Canada, as well as the business and labour communities, to assess without prejudice Canada's present economic prospects, the alternative solutions and their consequences. The Committee recommends that they consider seriously the option of bilateral free trade with the United States.

**ANNEXES
and
APPENDICES**

ANNEX A

Comparative Wage Rates between Canada and the United States

No single factor was mentioned more frequently during the Committee hearings as contributing to declining Canadian competitiveness than wage levels. Mr. R. D. Southern of ATCO, expressed the overall concern this way:

"For the manufacturing industry, of which ATCO is a part, labour is the primary cost factor of production. Employee compensation accounts for 75 per cent of our value added in the manufacturing sector in Canada. There has been a growing concern that our products are being priced out of world markets because of exceptionally large increases in costs and prices attributable to large wage settlements. It is a widely publicized fact that wage settlements during 1974 and 1975 in Canada were double those in the United States. From June, 1974 to June, 1975 average weekly wages in Canadian manufacturing increased by 18 per cent, while the United States the increase was less than 9 per cent. This had a resultant detrimental effect on our unit labour cost. The large wage and salary increases, in concert with the higher exchange value of the Canadian dollar, beginning in 1970, gave the result that unit labour costs in Canadian manufacturing industries increased faster than in the United States between 1970 and 1974." (II, 2:17)

Mr. R. W. Chorlton of Wajax compared the wage rates in his equipment company with his U.S. partners' wages.

"Five years ago our wage rate was \$.60 an hour lower than our U.S. partner. Today we pay \$.60 an hour or 10 per cent more in direct labour rates than our U.S. counterpart and by virtue of the lower volume probably do not obtain the same level of productivity." (II, 9:21)

While the average level of Canadian wages moved higher than the U.S. wage levels, witnesses reported significant differences in individual industries. In forest products, electrical machinery, business forms, telecommunication equipment, Canadian wages were substantially higher than U.S.; in carbon steel and automotive assembly approximate parity exists; in a number of other areas such as auto parts, farm machinery and specialty steels, Canada retains a diminished wage advantage.

Simple hourly wage differentials (Table 1) may present a somewhat biased picture of comparative labour costs in the two countries, as there are some basic differences in the base employed by the two countries in calculating wage increases. Further, testimony by witnesses indicated that in some industries fringe benefits were more generous in the United States as compared to Canada. For example, Du Pont's management reported that in a similar fibre plant, Canadian wages were 109 per cent of American but the total remuneration *including benefits* to a Canadian worker was 98 per cent of the U.S. level. The figures for a similar petrochemical plant were 106 per cent and 95 per cent respectively. Some social programs paid, in part, by contributions from employers in the United States are provided by the state in Canada. At least some of the higher wages paid to workers in Canada is taxed to help finance these programs.

Despite this caveat, money wages increased so much faster in Canada than in the United States that an unusual combination of forces must have been at work. No

thoroughly convincing rationale of why Canadian manufacturing wage rates rose so dramatically was presented to the Committee, but several contributing factors were suggested. These factors fall into two broad categories: those related to the "tightness" of labour markets, i.e., the balance between aggregate demand for and supply of labour, and those related to changes in the structure of labour markets such as social security, minimum wages, unionization, etc. Because of the central importance of wage rates and the emphasis put on them by witnesses, the Committee decided it was important to examine the causes in some detail.

Table 1

**Indexes of Output, Compensation, Unit Labour Costs & Hourly Earnings
in Manufacturing: Canada & United States. 1970 - 1976**

Item	Canada	U.S.	Item	Canada	U.S.
<u>Output Per Hour</u>			<u>Unit Labour Costs</u> (U.S. dollar basis) ³		
1970	100.0	100.0	1970	100.0	100.0
1973	114.8	114.5	1973	113.5	105.7
1974	114.8	109.8	1974	130.4	120.9
1975	116.7	109.9	1975	143.6	134.2
1976 ²	119.4	117.1	1976 ²	161.4	135.5
<u>Compensation Per Hour</u> (national currency)			<u>Average Hourly Earnings¹</u> (national currency)		
1970	100.0	100.0	1970	100.0	100.0
1973	124.8	120.7	1973	127.9	121.4
1974	140.3	132.8	1974	145.2	131.2
1975	163.3	147.7	1975	168.1	143.2
1976 ²	182.1	158.7	1976 ²	192.7	154.5
<u>Unit Labour Costs</u> (national currency)			<u>Real Hourly Earnings^{1,4}</u>		
1970	100.0	100.0	1970	100.0	100.0
1973	108.8	105.7	1973	110.3	106.0
1974	122.1	120.9	1974	112.9	103.3
1975	140.0	134.2	1975	118.0	103.3
1976 ²	152.4	135.5	1976 ²	125.8	105.3

1. Wage earners only

2. Preliminary

3. Indexes in national currency adjusted for changes in prevailing exchange rates

4. Index of average hourly earnings divided by the index of consumer prices to adjust for changes in purchasing power

Source: U.S. Bureau of Labour Statistics

1. *Aggregate Demand Factors*

Canadian labour markets appear to have been relatively "tighter" during the 1970-1975 period than those in the United States so that wages in Canada were being pulled up by the competition between employers for labour.

Output and employment grew more than twice as fast in Canada throughout the period as Table 2 shows.

Table 2
Average Annual Rates of Change
1970 — 1975

	Canada	U.S.
Total Gross Domestic Product	4.7	2.5
Per Capita GDP	3.2	1.6
Industrial Activity		
Total	4.4	1.7
Manufacturing	4.3	1.8
Manufacturing Employment	0.5	— 0.9
Private Sector Employment	3.2	1.2
Public Administration (civil)	5.3	2.7

Source: U.S. Statistical Abstract, 1977 Statistics Canada

The divergence was particularly marked in the years 1973-75. Surprisingly the "tightness" of the labour markets was not commented upon by either business or labour leaders who appeared as witnesses, but the Committee is convinced it had a significant impact.

Some of the differences in output and employment growth in the two countries can undoubtedly be attributed to the especially favourable world market conditions for Canadian products from 1972 to 1974. World demand for industrial materials, especially grains, base metals and mineral fuels, was very strong during these years. While both countries produce these materials, they occupy a much more central place in the Canadian economy than in the U.S. economy. Indeed, the United States is Canada's major customer for many of these products. Terms of trade turned sharply in favour of Canada from 1972 to 1974 and exports grew rapidly. This sharp growth in the primary sector induced a high level of investment and consumption expenditure which in turn resulted in a strong demand for manufactures and services. This demand would probably have generated some upward pressure on wages in Canada relative to those in the U.S., even in the absence of any structural changes and even if monetary and fiscal policies had been the same in both countries. However, throughout the period, monetary policy was much more expansionary in Canada than in the U.S. Fiscal policy, especially from mid 1974 on, was also more expansionary in Canada.

From Table 3 it can be seen that the Bank of Canada expanded the Canadian money supply much more rapidly than the U.S. authorities expanded their money supply. By 1975 and 1976 this growth undoubtedly contributed to the relatively better Canadian performance in terms of real growth, but also resulted in somewhat more rapid price increases in Canada. These accelerated price increases had a marked effect on wages by 1975 and would continue to exert upward pressure on them thereafter.

Table 3
Annual Percentage Money Supply Growth Canada and United States
1966 — 1976

	M1—Currency & Demand Deposits			M2—Currency and Demand & Time Deposits		
	(1) CAN.	(2) U.S.	(3) (1) - (2)	(4) CAN.	(5) U.S.	(6) (4) - (5)
1966	6.9	2.2	4.7	8.1	4.9	3.2
1967	9.7	6.6	3.1	12.2	11.1	1.1
1968	4.3	7.2	— 2.9	13.4	9.4	4.0
1969	7.5	2.6	4.9	9.7	— 1.5	11.2
1970	2.3	5.2	— 2.9	5.5	7.1	— 1.6
1971	12.8	6.4	6.4	14.4	11.3	3.1
1972	14.0	9.0	5.0	17.6	11.2	6.4
1973	14.5	6.3	8.2	13.4	8.8	4.6
1974	9.7	4.4	5.3	19.9	7.2	12.7
1975	13.7	4.2	9.5	17.5	8.5	9.0
1976	8.0	6.8	1.2	17.0	11.4	5.6
Avg. 1970-75	11.2	5.9	5.3	14.7	9.0	5.7

Source: May 1977 Economic Annual Review, Dept. of Finance, Canada. Board of Governors of the Federal Reserve System, Federal Reserve Bulletin (monthly)

Fiscal policy (as measured by the size of government deficits) was also more expansionary in Canada than in the U.S., especially in 1974 and 1975. This fiscal stimulus was partly responsible for the better performance of the Canadian economy over this period and thus also for the greater upward pressure on wages in Canada. But the size of deficits does not tell the whole story. The public sector expanded much more rapidly in Canada than in the U.S. and this rapid expansion in turn generated considerable upward pressure on Canadian wages.

Public sector employment grew especially rapidly from 1970 to 1975. Employment in "public administration" in Canada expanded by a phenomenal 30 per cent between 1970 and 1975 compared to approximately 18 per cent for private sector employment. Thus, as it had been doing throughout most of the 1960s, the public sector was competing aggressively for many types of labour and in the process was exerting upward pressures on wage rates.

Faced with this strong demand for labour by the public sector, private sector employers have been forced to increase wages to retain labour. The Canadian labour market is not segmented. Employees will move to government jobs if the terms in industry employment are not commensurate. The point was well put by M. Ian Barclay of British Columbia Forest Products Ltd..

"... we have a real dilemma because the public sector and the service sector have extraordinary wages compared to ours and we are looking at things where we want a qualified person to run a very expensive piece of machinery 150 miles from nowhere..." (II, 6:34)

In contrast, in the United States, while civilian public sector employment grew somewhat more rapidly than private sector employment during this period (18 per cent as compared with 12 per cent), military employment *fell* by 33 per cent so that total public sector employment (military plus civilian) rose by only 8 per cent.

In the overall, between 1970 and 1975, the number employed in Canada increased by 19.5 per cent compared to 8.5 per cent in the U.S. In the manufacturing sector Canadian employment increased by 3 per cent compared to a 5 per cent decline in the U.S. Unemployment rates, which had averaged one-half percentage point higher in Canada during the late 1960s, were about the same as the United States over the period 1970-75 and about one percentage point lower in 1974-75. While the impact that relatively stronger demand for labour in Canada has had on Canadian wages cannot be precisely assessed, the Committee concludes that at least part of the more rapid rise in Canadian wages during the 1970s was attributable to the stronger demand for labour.

2. Structural Factors

Changes in the structure of labour markets during this period also contributed significantly to the more rapid escalation of wage costs in Canada. While many changes contributed to rapid wage increases during this period, in the opinion of the Committee, the most important of these structural changes were:

- (i) Changes in public sector wage policies and the increased role of collective bargaining in public sector wage determination;
- (ii) Changes in many social security benefits and unemployment insurance benefits in particular;
- (iii) Rapid increases in minimum wages; and
- (iv) Increased expectations of workers for a progressively higher standard of living leading to deteriorating labour relations in the private sector.

Each of these will be discussed below in some detail.

(a) **Public Sector Wage Policies.** The rapid growth in the demand for labour by the public sector contributed during the period 1970-76 to sharp increases in wage rates. In the opinion of Mr. Robert Scrivener of Northern Telecom:

"... labour and benefits costs and productivity levels are being established, and will continue to be established, by the public sector in Canada, while in our principal competitor, the U.S., they are being established by the private sector; the further downstream we look, the wider the Canada-U.S. wage-productivity gap will develop in favour of the U.S." (II, 3:12)

This opinion was echoed by Mr. Walter Ward of Canadian General Electric who stated that one factor explaining the wage explosion in Canada was:

"the settlements in the public and quasi-public area which were significantly higher than they had been historically and higher than increases taking place in the private sector." (I, 38:9)

Because of the shift in relative employment between the private and public sectors it is surprising to find that the actual increase in public sector wages between 1970 and 1975 was not substantially higher than the increase in wages in manufacturing and in the service sector. According to Statistics Canada, the average

percentage increase in average gross wages in the public sector was 62.3 per cent between 1971 and 1975 (provincial 63.6 per cent, federal 58.2 per cent and municipal was 58.2 per cent). In the private sector, the percentage increase for the manufacturing sector was 60.7 per cent and for the service industries 58.5 per cent.

But a strong demand for labour by the public sector is only one of the reasons for rapidly rising wages in the public sector. A second and perhaps equally important factor has been the spread of collective bargaining in the public sector. The number of employees in the public sector covered by collective agreements rose dramatically during the last ten years, as can be seen from Table 4.

Table 4
Per Cent of Employees Covered by Collective Agreement by Major Industry Group, 1968 — 1975

	Non-Office Employees		Office Employees	
	1968	1975	1968	1975
Mining	77	83	5	11
Manufacturing	72	76	9	10
Transport, Comm., Util.	85	88	46	44
Service	34	46	12	25
Public Administration	46	97	24	92

Source: Labour Canada : *Working Conditions in Canadian Industry*.

Academic research has established that initial agreements usually result in above average settlements, and this rapid growth in unionization is likely to be reflected in larger-than-normal pay increases in the public sector.*

As the percentage of public sector employees covered by agreements stabilizes, the impact of this initial agreement effect should diminish. Mr. Lynn Williams of the United Steelworkers and Mr. Dennis McDermott of the United Auto Workers pointed in their testimony to certain necessary but one-time developments which accounted for the particularly rapid growth in provincial and municipal wage settlements. They noted that before the increases of the early 1970s hospital and municipal workers' wages had been very much out of line with other Canadian workers. They did not expect the trend to persist.

While this "initial agreement effect" may be temporary, the bargaining environment for public sector wage settlements does differ from that of the private sector. The government lacks a single measure of performance, such as profit, which would indicate when "excessive" wage settlements were being offered. In addition, the public sector is often involved in the production of services, some of them of vital importance to the country as a whole. Customers of services cannot dull the impact of a possible strike by stockpiling to the same extent that customers of goods producing industries can. Many health services, police protection, communications, etc. have to be consumed when needed. There is little scope for rescheduling

* Cousineau & Lacroix, *Wage Determination in Collective Agreements in the Public & Private Sectors*, Economic Council of Canada, 1977.

consumption of these services. Labour providing vital services has, as a group, much greater power than labour in other sectors.

There are, then, two major reasons why public sector wage settlements differ from private: the different disciplining forces acting on the negotiating parties and the larger proportion of vital services provided. Historical differences between the private and public sector in negotiating practices have been eroded in the last two decades. Public sector employees have gained the right to unionize and to strike. Their right to participate in political activity has also been liberalized. There are obvious social benefits from extending such valuable rights, but the dangers of a dramatic or steady exercise of power by public employees on the competitiveness of the private sector and eventually on their own well-being have been enhanced by these changes.

(b) Social Security. A second structural factor which has contributed to upward pressure on wages in Canada relative to the U.S., is the relative improvement of the Canadian income security programs, particularly unemployment insurance. During the 1970s, the duration, level, and qualifying periods for benefits in Canada were liberalized much more rapidly than was the case in the U.S. These more liberal U.I. provisions in Canada have greatly increased frictions in the labour market and placed upward pressure on Canadian wage rates.

This phenomenon is now well documented in economic literature. Although this analysis concentrates mainly on the effect of Canadian U.I. revisions on unemployment rates rather than the effect on wage rates, the effect on wages can be inferred. These studies indicate that the 1971 U.I. revisions increased Canadian unemployment rates by one to two percentage points. This implies that at any given level of unemployment in the mid 1970s, wages could be expected to increase 0.5% to 1.0% per year faster than at the same level of unemployment in the mid 1960s.

Several witnesses mentioned unemployment insurance as one of the reasons they were having some trouble attracting and retaining employees. For example, Mr. R. K. Groome, President of Hilton, Canada, testified:

"we have had many experiences where people have refused jobs. I can give you one example: Not too long ago we had to lay off a few cocktail lounge people because business was too slow. We offered them food waiter jobs instead. They declined, saying that they would prefer to be laid off so they could draw their unemployment insurance in that manner, because they did not wish to do the heavier work or the more complicated work of serving food as against serving beverages." (II, 21:25)

The Committee does not question the necessity of maintaining an adequate unemployment insurance system to protect workers from serious hardships during recessions. Nevertheless, the upward pressure which the present unemployment insurance system exerts on wages in Canada should be recognized.

(c) Minimum Wages. Over the decade from 1967 to 1976, the U.S. Federal minimum wage was increased by about 65 per cent while the average Canadian minimum wage was increased by 180 per cent. During this period the average Canadian minimum wage increased from about 75 per cent of the U.S. federal minimum wage to 120 per cent of the U.S. minimum wage. (See Table 6 on page 75 of the report) In mid-1977, the average minimum wage in the Canadian provinces

was \$2.85 an hour, much higher than in the many contiguous U.S. states and 15 per cent higher than the U.S. federal minimum of \$2.50 an hour. Moreover, there are many more exemptions under the U.S. minimum wage legislation than under Canadian statutes, so that the effective differences are even greater than is indicated by the difference in rates.

Increases in minimum wage rates have two important impacts. First, they put great pressure on wages just above the minimum and, through time, on all wage rates as higher rates are adjusted to maintain long established differentials. Second, increases in minimum wages directly increase costs and reduce employment in low wage manufacturing and service industries. (One industry that is particularly adversely affected is the hotel and restaurant industry as discussed in Chapter IV:3 of the report.)

The original rationale for minimum wage legislation was to better the lot of lower paid employees. Witnesses questioned that the anticipated benefits of this legislation have been realized and whether this approach is the best means of pursuing this objective. Mr. John Bulloch of the Canadian Federation of Independent Business argued that the minimum wage has reduced the number of jobs available to this group and in particular, many apprentice-style jobs which were low paying, but where the employee was receiving training in a skill that would generate income later, disappeared. The high unemployment rates among teenagers appears to be, in part, a result of the incidence of minimum wage laws.

(d) Labour Relations. It would appear that the industrial relations climate underwent a major change in the 1970s. Increasing acrimony, protracted negotiations and a marked increase in time lost due to strikes and lockouts characterized the labour relations scene from 1970 to 1976. According to U.K. statistics,* Canada had the dubious distinction of having more days lost per thousand people employed than any other developed country. Canada's average over the decade 1966-1975 was 38 per cent higher than that of the United States, 138 per cent higher than that of the U.K. and 345 per cent higher than West Germany. The bulk of time lost was in the private sector but the proportion of man-days lost to strikes and lockouts in the federal public service and federal industry grew to 11.3 per cent by 1975. This dismal record was maintained in 1976 when Canada edged out Italy as losing more days in strikes than the listed 54 other countries; Canada lost 2.27 working days for each worker, Italy 2.2 days. The United States, by contrast, lost only about one day. Fortunately, by 1977 the situation had improved dramatically with 70 per cent less man days lost than in 1976.

While there can be no doubt that Canadian competitiveness suffered because of increased time lost to strikes and strike-related activity and because of the accompanying reduction in cooperation between labour and management, the reasons for this deteriorating climate are far from clear. Factors suggested to the Committee to explain the situation, at least in part, included: (a) the behaviour of wages in the public sector; (b) increased uncertainty due to rapid inflation; (c) increased expectations of manufacturing and service employees because of the buoyant state of output and exports from 1972 to 1975; (d) an increasingly political orientation of unions.

* *Department of Employment Gazette*, United Kingdom, December 1976

The major impact of the public sector on private sector wages is through competition for labour in the market and rising wage rates. These have been treated in detail above. Other effects may also be important, however.

One such effect is in the area of fringe benefits. Industry was particularly concerned about the benchmarks being set by the public sector as far as fringe benefits were concerned. Mr. Walter Light, President of Northern Telecom, pointed out that his company was paying more in Canada than in the United States for labour and of the average Canadian wage, 72 cents was for benefits including pension plans, holidays etc. The company was apprehensive that the "tendency is for unions to want to match the fully-indexed pension plans that the government has." (II, 3:17)

There can be little doubt that the rapid inflation from 1973 caused greatly increased difficulties for parties at the bargaining table. Long established underpinnings for wage relationships were destroyed. Labour felt that they had been cheated out of real wages negotiated in the previous contract, especially when that contract had a duration of more than two years. Determined to "catch up" for these perceived losses, labour was wary of signing long contracts unless awarded high wage increases or cost of living allowances (COLA) clauses as insurance against future inflation. On the other hand, after 1974 businesses perceived themselves to be faced with softening world and domestic markets and to be exposed to intensified import competition. These sharp differences in perceptions made bargaining very difficult and undoubtedly resulted in more strikes and in increased length of strikes when they did occur.

While the foregoing reason explains in part the long duration of strikes in the last three years, it is but one contributing factor, and other useful suggestions were made in testimony. Mr. Lynn Williams of the United Steelworkers noted that it was extremely difficult under Canadian law to modify an agreement, once negotiated, while it was in force. Consequently, both parties took great care and time in ensuring that they could live with all the clauses of the agreement over its full term. Different patterns of industrial specialization, historical and legal differences and the complexity of collective bargaining agreements may provide partial explanations for the phenomenon. As well, in Canada, there is a fairly widespread tradition of plant-by-plant bargaining as opposed to the industry-wide bargaining in the U.S. which may contribute to the Canadian total of days lost due to strikes.

In addition to the impact of inflation on expectations, the buoyant state of the economy from 1972 to 1974 undoubtedly led to greater expectations about the increase in real wages than was appropriate. Large increases in resource and agricultural prices led to increasing expectations and wage rates in this sector. Strong revenues of government made it easy for the public sector to increase wages of all public employees, and made governments particularly vulnerable to claims of those involved in the provision of services to export industries. Employees in other sectors also perceived the economy to be "strong" and felt entitled to receive increases similar to those being paid in the resource sector. While it is extremely difficult to quantify the impact of these rising expectations on industrial relations after 1972, there can be no doubt that they did make bargaining more difficult.

It was also suggested that Canadian unions had become more "political" in their orientation and were less aware of the economic realities than their U.S. counterparts. Although there was a predictable tendency for management witnesses to argue that a more constructive approach by labour would help in improving labour relations, the Committee was impressed by the competence and awareness of both business and labour leaders of their common problems and their mutual interest in remaining competitive. The specific issues raised by industry leaders were that: the labour movement in the United States was better informed about the situation of each industry and therefore more aware of the consequences of their demands on job opportunities in the future; the labour movement in Canada was more politically involved than in the United States and therefore more likely to be influenced by other than economic considerations.

Mr. Laurent Thibault, an economist with the Canadian Manufacturers Association, stated:

"... it is a generally accepted fact in Canada that many of our unions have in fact a different approach to how society should be run than, say, in most unions in the United States, which are generally recognized as business unions." (II, 4:64)

Despite these assertions, the Canadian labour leaders who testified before the Committee were well briefed on their industry's situation. Like the management witnesses, they buttressed their arguments with statistical information, although they understandably selected different aspects of their industry's prospects and experience than chosen by management. Mr. McDermott agreed that the direct political involvement of Canadian unions was more marked than that of U.S. labour. However, some European countries with far greater involvement by labour in the political process, have experienced much less industrial strife than Canada, at least as measured by man hours lost per thousand employees. Both Messrs. McDermott and Williams commented unfavourably on the lack of acceptance by business leaders in Canada of the legitimate role of labour leaders, a factor which they believed contributed to bad labour relations.

The most important criterion for improved labour relations is greater awareness of the reduced capability of Canadian industry to compete. The testimony indicated that labour and management had both learned from recent experience and were aware of each others' concerns and the country's deteriorating position. For example, Mr. Henri Lorrain of the Canadian Paperworkers Union said, in July 1977:

"I think the membership by and large recognizes the problem of the industry. I think I can make that as a general statement at this time... Usually the employees of paper companies base their demands on what they believe is their employers' ability to pay. In 1974 the employers in Ontario gave a large settlement to the woodworkers. They had second thoughts about it by the spring of 1975, and it was not extended to the employees of the manufacturing sector of the pulp and paper industry. At that time, of course, the workers were perhaps less concerned about ability to pay than about maintaining—not maintaining the higher rates than those of woodworkers, which they had had for decades—but at least maintaining some measure of parity with the employees of the same companies in Ontario. This is one instance where we forgot a little bit about their ability to pay. We wanted justice. Traditionally, I think our people have bargained on what they have assumed to be the employers' ability to pay." (II, 27:17, 21)

There are encouraging signs that this increased awareness is bearing fruit. According to Ontario's labour minister, in the first three months of 1977, man-days

lost in that province were 82 per cent lower than in the comparable period during 1976. It is noteworthy that the most successful Western industrial economy—the Federal Republic of Germany—is a society in which there is a broad sense of national purpose and a high level of mutual acceptance by business and labour leaders.

ANNEX B

Comparative Taxation Levels

(i) *Comparative Personal Income and Social Security Tax Levels*

Personal income taxes and social security taxes can have an impact on costs to the extent that they “push up” wages and payroll costs of regular employees, and through the effect they can have in the movement of bright young managers, professionals, and middle executives between companies in Canada and the United States.

While there is considerable variation in the rate of income and social security taxes across states and provinces, as of 1977 employees earning roughly \$20,000 and over faced higher rates of tax in Canada than in almost all states in the U.S., while those earning \$10,000 to \$20,000 paid about the same or somewhat less in most provinces compared to most states in the U.S. The married taxpayer earning \$20,000 and up who is the sole earner in the family is treated more harshly in Canada compared to his U.S. counterpart, while single taxpayers and those with working spouses in Canada in this income range are at only a very mild disadvantage compared with their U.S. counterparts in most states. It should also be noted that the U.S. tax system places great emphasis on itemized deductions compared to Canada. In aggregate itemized deductions represent about 16 per cent of the comprehensive tax base in the U.S. compared to 9 per cent for Canada. For this reason, tax burdens of individuals with similar incomes may differ widely.

It should be noted that average tax rates do not tell the whole story, however. For individuals with above average earnings transfer payments may go a long way to offset higher personal income tax burdens in Canada. Payments received via family allowances and hospital and medical insurance have no U.S. counterpart. Moreover, the combined old age security/Canada Pension Plan benefits in Canada are likely to be higher upon retirement than U.S. social security payments. Thus the net tax position (taxes minus transfers) of most middle income employees in Canada is likely to be about the same or lower than their U.S. counterparts in states with average tax levels.

Because of the wide variation in tax levels across states and provinces and because of the greater reliance on itemized deductions in the U.S. tax system, it is not surprising that the Committee received conflicting testimony as to the impact of the personal income tax on salaries of managers in Canada. On the one hand, the Committee heard testimony from the heads of some Canadian companies who found it difficult to bring people from the United States because of the tax situation. For example, Mr. David Barr of Moore Corporation said that a manager would have to be paid a 33½% increase to bring a \$25,000 U.S. salary to the break-even point in Canada. Mr. Alfred Powis of Noranda testified that Canadian personal income taxes

were much higher than those in the United States and told the Committee his company had to pay someone who was making \$20,000 in the United States \$34,000 to give him the same take home pay in Canada. On the other hand, Mr. R. D. Brown of Price Waterhouse & Co. suggested that there is not much difference in Canadian and U.S. personal tax rates.

(ii) *Corporation Income Tax*

Corporation income tax structures in both Canada and the U.S. are exceedingly complex with the result that effective rates of tax paid in both countries vary greatly across industries and companies. On average, however, the corporate tax burden is somewhat lower in Canada than in the United States. The Department of Finance calculates that the average rate of tax on book profits in Canada was 35 per cent in the period from 1970 to 1976 compared to 39 per cent in the United States.

Canadian corporate tax rates are, in general, a little lower than the U.S. rates. Combining federal and provincial levies, the rates vary between 46 and 51 per cent in Canada, whereas the comparable figure in the United States is about 50 per cent. For manufacturing and processing industries, the Canadian rates are substantially lower, running between 40 and 45 per cent. While Canadian treatment of losses is slightly less advantageous than that in the United States, this is more than offset by the more favourable treatment accorded to intercorporate dividend payments.

In general, the United States provides stronger incentives to new investment through the investment tax credit than does Canada. Mr. Brown of Price Waterhouse reported that in the United States:

"Depending on certain factors, 10 or 11 per cent of the cost of new capital investment in plant and equipment is allowed as a tax credit. In Canada, we have an investment tax credit, but it is only 5 per cent. Furthermore, that 5 per cent must be used to reduce the basis of the asset for further depreciation purposes. This is not true in the United States." (I, 28:6)

While the Canadian credit can be as much as 10 per cent on certain investments in depressed areas of the country, the generally lower credit combined with the reduction of value of the asset for depreciation purposes means that the Canadian tax credit is usually less than half as valuable as the U.S. one. On the other hand, Canada permits very much faster write-offs for capital cost allowances (CCA) than does the U.S. In Canada, new manufacturing and processing equipment can be written off in two years whereas in the U.S. many types of machinery have to be depreciated over 10 to 15 years for tax purposes. This gives a very great cash flow advantage to capital intensive firms in Canada, especially in periods of high inflation and high interest rates, and more than offsets the effect on cash flow of the higher tax credit in the U.S.

In spite of investment tax credits and accelerated CCA, industry in Canada, as in the United States, is exposed to the risk of overtaxation in periods of rapid inflation. As Mr. John Stenason of Canadian Pacific Investments explained:

"... income tax payments are based on earnings calculated on the basis of historic costs and do not make allowance for the much higher costs of replacing plant and equipment during an inflationary period. This means that corporate earnings and corporate taxes are overstated and this has the effect of shrinking funds available for re-investment in plant and machinery."*

* In a letter of December 7, 1977 to the Committee following his testimony.

As an assistance in capital formation, Mr. Walter Ward of CGE pointed out that the Swedish system allows tax-free reserves of up to 40 per cent of pre-tax profits for future investment and 60 per cent of inventories to be written down immediately. He judged that this system would be a tremendous help in the availability of cash flow for re-investment in industry.

The Committee did not examine this complex issue in detail. It would seem appropriate however that the government should work with the Canadian Institute of Chartered Accountants to try to devise a satisfactory system of coping with this problem. While inflation continues, a company under the traditional accounting system, will be forced to delay investment and neglect to refurbish its plant. Inevitably there will be unfortunate production and trade consequences.

Canadian producers, especially those who carry large inventories, are at a tax disadvantage relative to their U.S. counterparts in periods of inflation because inventory profits in Canada must be calculated on a "first-in-first-out" (FIFO) basis while American producers have the option—which most have taken—of calculating these profits on a last-in-first-out basis (LIFO) for tax purposes. Under the LIFO system, the most recent (and generally more expensive) acquisition is charged against current income, thus reducing taxable income to the advantage of U.S. companies. This advantage has been partially offset (at least at current rates of inflation) by the introduction in Canada in April, 1977 of a 3 per cent inventory valuation credit. Such a credit is only a partial response to the problem however.

In the United States, the DISC (Domestic International Sales Corporation) also provides a considerably reduced rate for profits earned on exports. The provisions of DISC are complicated but the effect is roughly to reduce federal taxes on income earned from exports to three quarters of the level that would otherwise be paid. The effects of DISC on Canadian-American trade are difficult to assess. The tax concessions would only be expected to lower costs of American export goods by one to two per cent. However, one to two per cent on gross revenue can make a considerable difference to profit levels. Mr. Tom Burns of Industry, Trade and Commerce believed

"that the principal benefit taken by U.S. exporters has been in terms of the capacity to dispose of greater resources financially, either in profits, expanded production, investment or what-have-you, rather than on the price side." (I, 27:17)

A U.S. Treasury Report summarized the operations of DISC for 1972. Of \$16 billion of exports through DISC, 22.1 per cent were destined for the Canadian market. The U.S. Treasury estimated that DISC involved a loss of revenue of approximately \$250 million. Prorating this loss, a rough estimate of an annual \$50 million subsidy to U.S. exports to Canada can be derived. A specially established panel of GATT ruled in 1976 that DISC was an export-subsidy scheme and therefore counter to the GATT rules. Canada could take retaliatory countervail action, if injury has occurred. The testimony of Canadian industry witnesses, however, indicated that DISC had not contributed markedly to their problems. The DISC legislation was recently altered by the U.S. Tax Reform Act and will in future only apply to income earned on exports above those in a base period. From data on

DISC imports gathered under the Canadian Import Surveillance program, the Department of National Revenue estimates that \$4 billion of U.S. exports to Canada will no longer be subsidized under DISC. The U.S. is also on record that it would remove DISC as part of a general agreement, under GATT, for the restriction of export subsidies.

(iii) *Resource Taxation*

While corporations in general face lower rates of income taxation in Canada than in the U.S., resource based industries in Canada must pay heavy additional fees, taxes and royalties which leaves them in a disadvantageous position vis-a-vis their American counterparts. The Department of Finance calculates that while the effective rate of tax on income for all taxes is six percentage points lower in Canada than in the U.S. for all industries, it is 12 and 24 percentage points higher in Canada for the mining and forestry industries respectively.

A major problem for the Canadian resource industries, and particularly the mining industry in recent years relates to the jurisdictional disputes between the federal and provincial levels of government over the right to tax. The mining industry's tax incentive structure was substantially altered in 1971 by changes in federal tax policy which removed some of the advantages which the industry had traditionally enjoyed. However, the impact of this change was compounded by steps taken within a couple of years by the provinces to tax away the profit generated in the prosperous 1973-74 period, which, it is now apparent, was due to cyclical factors.

Mr. Alfred Powis, President of Noranda, termed as "devastating" the overall impact of the federal governments' 1971 tax reform coupled with the punitive taxes and royalties of the provinces which the federal government disallowed as expenses. In terms of competitive position, he said, Canadian taxes were more than double those in parts of the United States. As evidence of this his company prepared for the Committee some tables of comparable mining operations in its Brenda Mine concern in B.C., in Ontario and in Nevada. (Tables 1 and 2 on following page)

Both Mr. Stenason and Mr. Powis considered that the interaction of federal and provincial taxation measures were constraining new mine developments. Mr. Powis stated:

"It is our conviction that unless you discover something extraordinarily rich in Canada, it cannot be developed under today's tax circumstances. You cannot finance it; you do not have the prospect of making a reasonable rate of return. We are still looking for mines in Canada as well. We are doing it as an act of faith, I suppose . . . sooner or later some common sense will prevail in this federal-provincial battle over taxing." (I, 36:12)

A recent study by Ontario's Ministry of Natural Resources indicates a heightened awareness by some provinces of the impact from the double tax burden. The study found that tax changes in recent years have resulted in a 17 to 20 per cent reduction in mining investment in Ontario and 21 per cent in Canada as a whole. While the federal government made some modifications, effective January 1, 1976, reducing the corporate tax rate on production profits from 50 per cent to 46 per cent, the speed in imposing the original increased taxes was dazzling compared to the slowness in removing them to alleviate the difficulty.

Table 1

Brenda Mines Limited Tax Comparison — Recent Conditions

Thousands of Dollars	In B.C. (A)	In Ont. (B)	In Nevada (B)
Earnings before Taxes	\$5,818	\$5,818	\$5,818
Provincial/State Taxes	2,645	1,389	291
Federal Taxes	1,455	1,455	1,327
Earnings After Taxes	\$1,718	\$2,974	\$4,200
Effective Tax Rate	71%	49%	28%

(A) Results shown are actual results for 1975.

(B) Assumes that, if the mine happened to be in Ontario or Nevada, exactly the same revenues and costs would apply.

Table 2

Brenda Mines Limited Tax Comparison — Prices Doubled

Thousands of Dollars	In B.C. (A)	In Ontario. (B)	In Nevada (B)
Earnings before Taxes	\$45,789	\$45,789	\$45,789
Provincial/State Taxes	26,687	14,220	2,289
Federal Taxes	11,447	11,447	14,596
Earnings After Taxes	\$ 7,655	\$20,121	\$28,904
Effective Tax Rate	83%	56%	37%

(A) Assumes that costs are at the same level as in 1975 but that prices of copper and molybdenum are doubled.

(B) Assumes that, if the mine happened to be in Ontario or Nevada, exactly the same revenues and costs would apply.

It is the Committee's opinion that the Canadian resource industry, particularly the non-fuel mineral industry and the forest industry have suffered in recent years from over-taxation relative to the United States, mainly as a result of federal and provincial jurisdictional disputes. This is in the two industries which are the greatest "net" earners of foreign exchange for Canada. The non-fuel mining industries face enough serious challenges from slumping prices, large inventories and precarious markets without punitive taxes. The same is true in the forest industry which is being faced with serious competition from the fast-growing tree plantations in the southern United States. When asked how the federal-provincial resource tax conflict could be resolved, Mr. Powis said:

"a nice simple solution would be for various governments to decide that 50 per cent is a high enough tax rate and maybe they should split that 50-50." (I, 36:13)

(iv) Indirect Taxation

Perhaps the most important difference in the structure of Canadian and U.S. taxes on business relates to taxes other than corporate income taxes, in particular to the much heavier indirect taxes in Canada. Mr. R. D. Brown, a tax expert, explained that these hidden taxes—sales taxes on equipment and supplies, capital taxes, business and franchise taxes—were applied to business whether they had profits or not. The general manufacturing sales tax of 12 per cent had no equivalent south of the border.

Mr. Brown commented:

"The impact of these other taxes is, therefore, a "front-end load" on Canadian industry. This is particularly important in years of high capital investment, or the initial years of a new company. There is also this heavy burden of other taxes, basically of a fixed character unrelated to profits, which means that the Canadian tax system can be particularly harmful in loss years or years of low profits, and tends to accentuate the business cycle in Canada since the tax burden is particularly heavy when industry is not doing well." (I, 28:6)

Mr. Brown considered the Canadian tax structure as inefficient. After a detailed comparative study of the tax systems in Canada, United States and Northern Europe for one industry, he concluded that the Canadian system imposed more burdens on its industry than the tax systems of other countries. As to its effect on competitiveness, Mr. Brown said:

"our tax system does not help and indeed hinders the aggregate level of productivity in Canada and tends to make our products have a more difficult time in world markets." (I, 28:14)

He concluded that the same revenue could be raised in Canada with greater emphasis on taxing profits and less emphasis on indirect taxes.

While it is difficult to obtain a precise estimate of the amount of sales taxes paid on intermediate goods, it appears that \$750 to \$1000 million of federal manufacturers sales tax is paid at this level. A small amount of provincial sales tax is also paid at this level. Thus the burden of these inefficient taxes constitutes about one fifth of the burden of the corporate income tax and for many industries may more than offset the benefits of the lower Canadian corporate tax described above. This additional burden increases the difficulties of Canadian firms in competing with U.S. and European firms which face no such tax.

Several witnesses suggested that this burden could be eliminated by switching to a value added tax (VAT). Mr. Walter Ward of Canadian General Electric pointed out that European tax policies assist manufacturers through their VAT procedure. They effectively subsidize exports since the value-added tax does not apply to exports thereby allowing the manufacturer to get a better export price. The VAT does apply to imported products, however, which helps to pay high social service costs and at the same time makes European manufacturers more competitive. Mr. Brown agreed that a VAT system would make Canadian industry more competitive both at home and abroad. While he noted that it might shift a larger percentage of the sales tax burden directly to the consumer, he underlined the VAT's positive effect of exempting industry from all sales tax costs on inputs of production.

While the VAT system has many attractions, the Committee recognizes that the introduction of such a system would be very difficult in Canada where the sales tax field is shared between provincial and federal governments.

Therefore, even if the VAT does not appear to be a practicable way to deal with the problem of taxation of producers' goods at the present time, the Committee considers it important to find some solution to this problem in order to improve Canadian competitiveness. Several possibilities have been suggested. The exemption from manufacturers and provincial sales taxes of a broad range of producers' goods would certainly alleviate, though not eliminate this problem. This method would

cause a minimum amount of administrative problems under existing tax structures, but could involve a significant revenue loss. A second method would be to rebate to producers the sales tax which has been levied on inputs which they purchase. While this solution is administratively more difficult than the first, it would probably provide the maximum of benefit to producers with a minimum of loss of revenue. Since proposals recently advanced by the Minister of Finance for the replacement of the manufacturers sales tax with a wholesale tax are to be re-examined, the Committee recommends that the above proposals or other methods designed to reduce the "front-end load" tax on producers be given urgent consideration.

TABLE 1
CANADIAN TRADE BALANCE WITH UNITED STATES BY MAIN CATEGORIES, 1965-1977

	1965	1966	1967	1968	1969	1970	1971	1972	1973	1974	1975	1976	1977
	(millions of dollars)												
Live Animals, Food, Feed, Beverages and Tobacco	488 385 103	507 414 93	476 450 26	549 469 80	620 526 94	689 516 173	672 540 132	757 655 102	979 992 87	918 1241 -323	952 1320 -368	1069 1553 -484	1290 1705 -415
Crude Materials	1,019 491 528	1,130 506 624	1,192 512 680	1,378 536 842	1,379 452 927	1,633 535 1,098	1,740 578 1,162	2,000 644 1,364	2,735 780 1,955	5062 1078 3984	5248 1432 3816	5363 1407 3956	5476 1788 3688
Fabricated Materials, Inedible	2,533 1,350 1,183	2,806 1,482 1,324	2,871 1,495 1,376	3,403 1,581 1,822	3,642 1,912 1,730	3,672 1,915 1,757	4,013 1,981 2,032	4,759 2,233 2,526	5,695 2,824 2,871	7250 4209 3041	6690 4044 2646	8527 4394 4133	10064 4968 5996
End Products	969 3,578 -2,609	1,769 4,452 -2,683	2,771 5,329 -2,558	3,864 6,244 -2,380	4,943 7,207 -2,264	4,987 6,832 -1,845	5,571 7,730 -2,159	6,354 9,193 -2,839	7,158 11,714 -4,556	8235 14,597 -6,362	8881 16,496 -7,615	10,738 17,944 -7,206	13,103 20,782 -7,679
Special Transaction Trade	24 241 -271	23 281 -258	23 236 -213	37 220 -183	31 148 -117	27 119 -92	26 120 -94	43 151 -108	40 192 -152	72 232 -160	63 266 -203	100 364 -264	59 299 -240
Total Trade with U.S.	5,033 6,045 -1,012	6,235 7,136 -901	7,333 8,022 -689	9,230 9,048 182	10,614 10,243 371	10,987 9,917 1,070	12,023 10,949 1,074	13,922 12,878 1,044	17,129 16,502 627	21,433 21,357 76	21,870 23,559 -1,689	25,953 25,662 291	30,193 29,543 1,350

Source: Statistics Canada Trade Data, May 1978.

Table 2
Canadian Trade in Energy with the United States

	1974		1977	
	Quantity	Value	Quantity	Value
	(\$ millions)		(\$ millions)	
<i>Crude Petroleum</i> (10 ⁶ bbls)				
Exports to U.S.	332.2	3,407	120.9	1,752
Imports from U.S.	—	—	19.6	284
Net Exports	332.2	3,407	101.3	1,468
<i>Natural Gas</i> (tcf)				
Exports to U.S.	959.0	494	993.8	2,028
Imports from U.S.	13.3	6	—	—
Net Exports	945.7	488	993.8	2,028
<i>Coal</i> (10 ⁶ tons)				
Exports to U.S.	0.7	20	0.2	11
Imports from U.S.	14.4	344	15.6	652
Net Imports	13.7	324	15.4	641
<i>Electricity</i> (10 ⁹ kWh)				
Exports to U.S.	15.4	175	16.7	377
Imports from U.S.	13.0	170	1.2	15
Net Exports	2.4	5	15.7	362
TOTALS OF ABOVE				
EXPORTS		4,095		4,168
IMPORTS		519		951
EXPORT BALANCE		3,575		3,217
<i>Miscellaneous</i>				
Liquified Petroleum Gases				
Refined Products and				
Radioactive Ores — Net Exports		308		509
TOTAL ENERGY EXPORT				
BALANCE		3,883		3,726

Compiled by Department of Energy, Mines and Resources, July, 1978

Appendix 2

NON-TARIFF MEASURES NOTIFIED BY THE UNITED STATES AND CANADA AGAINST EACH OTHER

United States Notifications vis-à-vis Canada

I Government Participation in Trade

Category: Government aids, procurement, monopoly practices, etc.

1. Subsidies to film producers
2. Domestic subsidies to stimulate exports (Michelin)
3. Monopolies operated by Canadian Provincial Liquor Boards
4. Government procurement including provinces.

II Customs and Administrative Entry Procedure

Category: Valuation procedures

1. Arbitrary valuation and surtax

III Standards Involving Imports and Domestic Goods

Category: Requirements Concerning Marketing; Industrial Standards

1. Imports permitted only in can sizes established by the Canadian Government
2. Canadian Standards Association for Electrical Equipment

IV Specific Limitations

Category: Screen time quotas and other mixing regulations; embargoes and other restrictions of similar effect

1. Restrictions on trade in recorded television programmes
2. Prohibitions, with exceptions, on imports of used aircraft and automobiles
3. Quotas on imported footwear

Canadian Notifications vis-à-vis United States

I Government Participation in Trade

Category: Government Aids, Countervailing duties; Restrictive practices tolerated by governments

1. Concessional Export Financing
2. Western hemisphere trading corporations

3. Domestic International Sales Corporation (DISC)
4. Countervailing duties
5. Activity by United States labour unions to restrict imports
6. Multinational corporations

II Customs and Administrative Entry Procedure

Category: Anti-dumping and valuation

1. Anti-dumping
2. American Selling Price
3. "Final list" valuation

Category: Customs classifications; Consular formalities and documentation

1. Special valuations
2. Uncertainty of TSUS classification
3. Customs Invoice Form 5515
4. Delays in customs services
5. Ports of entry for furs and fur products

III Standards Involving Imports and Domestic Goods

Category: Industrial standards; health and safety standards

1. Standards (plumbing and heating equipment, lumber, fire fighting equipment and electrical equipment)
2. Coast Guard inspection of safety equipment for use on United States Flag vessels

Category: Health and safety standards; requirements concerning marketing

1. Consumer product Safety Act
2. Fair Packing and Labelling Act, 1966
3. Marks of origin

IV Specific Limitations

Category: Embargoes and other restrictions of similar effect; quantitative restrictions

1. De facto prohibitions on imports of:
 - foreign-built dredges and other work vessels for use in United States territorial waters
 - foreign-built air-cushioned vehicles for use in coast-wide trade over water
 - containers of foreign manufacture on United States flag vessels
 - denatured industrial alcohol
2. Quotas on cotton textiles, butter substitutes, milk powder
3. Restrictions on use of imported nuclear materials
4. Copyright legislation "manufacturing clause"

V Charges on Imports

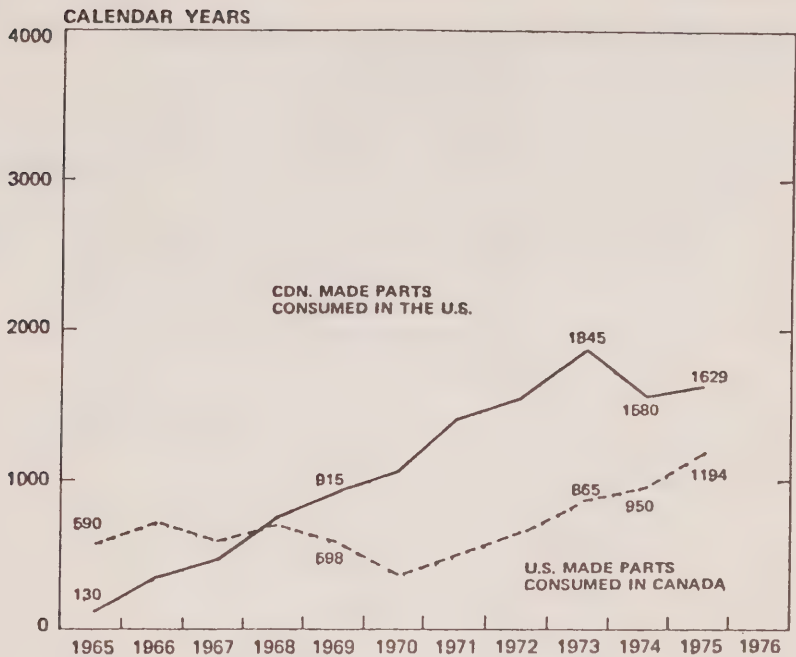
Category: Border tax adjustments

1. Excise Tax System
2. Measurement of alcoholic content of spirits
3. Escape clause tariff action

Source: Extracts from the Inventory of Non-Tariff Measures General Agreement on Tariff and Trade (GATT), Revised as of January 1974.

Appendix 3

NET AUTOMOTIVE PARTS
FOR ORIGINAL EQUIPMENT VEHICLE PRODUCTION
CANADA/U.S.A. TRADE
(NET OF PARTS USED IN VEHICLE EXPORTS/IMPORTS)
(MILLIONS OF DOLLARS)



SURPLUS/(DEFICIT)

• GROSS O.E. TRADE	(534)	(700)	(808)	(1050)	(1109)	(643)	(607)	(970)	(1234)	(1584)	(2104)	N/A
ADJUSTMENTS:												
IMPORTS RE-EXPORTED	75	338	687	1085	1458	1359	1556	1924	2305	2324	2683	N/A
EXPORTS RE-IMPORTED	(1)	(5)	(15)	(24)	(32)	(41)	(57)	(67)	(91)	(110)	(144)	N/A
• NET O.E. TRADE	(460)	(367)	(136)	11	317	675	892	887	980	630	435	N/A

SOURCE: FORD OF CANADA ESTIMATE

Appendix 4

COMMITTEE PROPOSAL FOR DISAGGREGATION OF AUTOMOTIVE TRADE FIGURES

I The Terms of the Equation:

Canadian Automotive Exports are made up of a) vehicles and b) parts

a) *Canadian vehicles exports* composed of:

- the value of Canadian-made parts in the vehicle = 1
- *plus* the value of U.S.-made parts in the vehicle = 2
- *plus* the value added in assembly in Canada = 3

b) *Canadian parts exports* composed of:

- original equipment parts (OEM) = 4
- aftermarket parts = 5

Canadian Automotive Imports are made up of vehicles and parts

a) *Imports of U.S. vehicles* composed of:

- the value of Canadian-made parts in the vehicle = 6
- *plus* value of U.S.-made parts in the vehicle = 7
- *plus* value added in assembly in U.S. = 8

b) *Imports of U.S. parts* composed of:

- original equipment parts = 9
- aftermarket parts = 10

II The Calculations:

A *To show the net value of original equipment parts (OEM):*

Exports = 4 - 6 + 1

Imports = 9 - 2 + 7

Trade Balance = (4 - 6 + 1) - (9 - 2 + 7)

Mr. Bennett estimated that (4 - 6) - (9 - 2) = \$435 million

Industry, Trade & Commerce estimated that 1 = approx. \$350 million
and 7 = approx. \$2400 million

Therefore 1975 OEM parts trade balance would be \$435 m + \$350 m -
\$2400 m = \$1615 million *deficit* in parts

B *To show the amount of new Canadian value-added in assembly operations (vehicles):*

Exports 3 less Imports 8 = no figures available

Trade balance in vehicles = 3 - 8

Appendix 5

STANDING SENATE COMMITTEE ON FOREIGN AFFAIRS (1975-1977)

Note: Commencing with Printed Proceedings Number 18 of the First Session of the 30 Parliament (1974-76), the Committee considered Canada-United States Trade Relations.

Issue No.	Date	Witnesses
18	July 11/75	<i>Economic Council of Canada—</i> Dr. André Raynauld, Chairman; and Mr. John Downs, Economist.
19	Dec. 11/75	<i>Departmental of Industry, Trade and Commerce—</i> Mr. T.M. Burns, Senior Assistant Deputy Minister — Operations; Mr. Charles Kelly, Assistant Director, Western Hemisphere Division; Mr. C.J. Wenaas, Chief, Canada-U.S. Division, Macro-Economic Analysis Group; and Mr. T.R.G. Fletcher, Assistant Deputy Minister — Tourism.
20	Dec. 18/75	Mr. E.B. Carty, Senior Advisers, Balance of Payments, Statistics Canada; and Mr. M.G. Kelly, Chief, Balance of Payments, International Division, Department of Finance.
21	Dec. 2/75 Dec. 9/75 Dec. 16/75	Report of Committee on First Phase of Study — entitled CANADA — UNITED STATES RELATIONS "Volume I — The Institutional Framework for the Relationship."
22	Feb. 10/76	<i>Department of Industry, Trade and Commerce—</i> Mr. T.M. Burns, Senior Assistant Deputy Minister — Operations; Mrs. Eileen A. Mahoney, GATT Division, Office of General Relations; Mr. Carl J. Wenaas, Chief, Canada-U.S. Division, Macro-Economic Analysis Group; and Mr. Charles J. Kelly, Assistant Director, U.S.A. Division, Western Hemisphere Bureau.

Issue No.	Date	Witnesses
23	Feb. 24/76	<i>Department of Industry, Trade and Commerce—</i> Mr. T.M. Burns, Senior Assistant Deputy Minister — Operations; Mrs. Eileen A. Mahoney, GATT Division, Office of General Relations; Mr. James Taylor, General Director, Western Hem- isphere Branch; and Mr. Carl J. Wenaas, Chief, Canada-U.S. Division, Macro-Economic Analysis Group.
24	Feb. 26/76	<i>Department of Industry, Trade and Commerce—</i> Mr. T.M. Burns, Senior Assistant Deputy Minister — Operations; and Mr. C. Douglas Arthur, Special Adviser (Auto- motive), Trade Policy and Planning Group.
25	Mar. 9/76 * Mar. 11/76	
26	Mar. 16/76	Dr. E.P. Neufeld, Director, International Finance Division, Department of Finance.
27	Mar. 18/76	<i>Department of Industry, Trade and Commerce—</i> Mr. T.M. Burns, Senior Assistant Deputy Minister — Operations; Mr. C.J. Kelly, Assistant Director, Western Hem- isphere Bureau; Mr. G. Elliot, Acting Director, General Trade Policy Branch; and Mr. John Donaghy, Chief of the GATT Division.
28	Mar. 23/76	Mr. R.D. Brown, Senior Tax Partner, Price Water- house & Co., Toronto, Ontario.
29	Mar. 25/76	Mr. Carl Beigie from the C.D. Howe Research Insti- tute, Montreal, Quebec.
30	Apr. 6/76	<i>Department of Industry, Trade and Commerce—</i> Mr. F.T. Jackman, General Director, Office of International Projects; Mr. William Grant, Director, Defence Programs; and Mr. O.W. Bennett, Chief, Market Research and Administration Division.

Issue No.	Date	Witnesses
31	Apr. 8/76	Mr. Patrick J. Lavelle, President, Automotive Parts Manufacturers' Association of Canada, Toronto, Ontario.
32	Apr. 29/76	<i>Department of Industry, Trade and Commerce—</i> Mr. T.M. Burns, Senior Assistant Deputy Minister — Operations; and Mr. C.D. Arthur, Special Advisor (Automotive), Trade Policy and Planning Group.
33	May 11/76	Mr. J.M. McAvity, President, Canadian Export Association, Montreal, Quebec.
34	May 13/76 May 18/76	*
35	May 25/76	Mr. David Culver, President and Chief Executive Officer, Aluminum Company of Canada, Ltd., Montreal, Quebec.
36	May 27/76	Mr. Alfred Powis, President of the Mining Association of Canada, Toronto, Ontario; and also President and Chief Executive Officer, Noranda Mines Limited; and Mr. Keith C. Hendrick, President, Noranda Sales Corporation Ltd.
37	June 8/76 June 22/76	*
38	June 10/76	<i>Canadian General Electric Company Limited—</i> Mr. Walter Ward, Chairman of the Board and Chief Executive Officer, Peterborough, Ontario; and Mr. V.L. Clarke, Vice-President in charge of Strategic Planning, Toronto, Ontario.

*Note: Issues numbered 25, 34 and 37 dealt with matters not related to the study of Canada — United States Relations.

Second Session 30th Parliament 1976-77

Issue No.	Date	Witnesses
1	Nov. 2/76	<i>Canadian Importers Association:</i> Mr. C.F. Sayers, President, Toronto, Ontario; and Mr. Keith G. Dixon, Executive Vice-President.
2	Nov. 4/76	Mr. R.D. Southern, President and Chief Executive Officer, ATCO Industries Ltd., Calgary, Alberta.
3	Nov. 16/76	<i>Northern Telecom Limited:</i> Mr. Robert C. Scrivener, Chairman and Chief Executive Officer, Montreal, Quebec; Mr. Walter F. Light, President; and Mr. Derek M. Davies, Vice-President — Marketing.
4	Nov. 18/76	<i>Canadian Manufacturers' Association:</i> Mr. Rod J. Bilodeau, President, Toronto, Ontario; Mr. Roy Phillips, Executive Director; and Mr. J. Laurent Thibault, Director of Communications and Economics.
5	Nov. 30/76	Mr. W. John Stenason, Executive Vice-President, Canadian Pacific Investments Ltd., Montreal, Quebec; and Mr. N.E. Wale, Research Department, Canadian Pacific Ltd.
6	Dec. 2/76	Mr. Ian A. Barclay, Chairman and Chief Executive Officer, British Columbia Forest Products Limited, Vancouver, British Columbia.
7	Dec. 14/76	<i>Ford Motor Company of Canada, Limited:</i> Mr. Roy Bennett, President and Chief Executive Officer, Oakville, Ontario; and Mr. W. Mitchell, Vice President, Finance.
8	Dec. 16/76	<i>The Steel Company of Canada, Limited (Stelco):</i> Mr. J.D. Allan, President, Toronto, Ontario; Mr. G.L. Waters, General Manager, Marketing and Commercial Planning; Mr. W.A. Darby, General Accountant — Taxation; and Mr. R.E. Heneault, Vice-President — Administration.

Issue No.	Date	Witnesses
8 (cont.)	Jan 27/77	<p><i>Atlas Steels:</i></p> <p>Mr. Allan V. Orr, Vice-President and General Manager, Welland, Ontario; and Mr. Carl Ohlson, Vice-President — Marketing.</p>
9	Jan. 27/77	<p><i>Canadian Association of Equipment Distributors:</i></p> <p>Mr. J.S. Thorp, Executive Director, Ottawa, Ontario.</p> <p><i>Dominion Road Machinery Co. Ltd.:</i></p> <p>Mr. B. Sully, President; and Mr. J.C. Freeman, Vice-President — Finance.</p> <p><i>Wajax Limited:</i></p> <p>Mr. R.W. Chorlton, President; and Mr. R.G. Willox, Vice-President.</p>
10	Feb. 8/77	<p>Mr. William Mounfield, President, Massey-Ferguson Industries Ltd., Toronto, Ontario. Mr. R.W. Main, Vice-President — Administration, Massey-Ferguson Ltd.; and Mr. Robert Snelgrove, Vice-President and Legal Counsel Massey-Ferguson Industries Ltd.</p>
Not printed (in camera)	Feb. 10/77	<p><i>Department of Consumer & Corporate Affairs—</i></p> <p>Mr. David French, Bureau of Intellectual Property</p> <p><i>Department of Industry, Trade & Commerce—</i></p> <p>Mr. N.R. Cumming; and Mr. S.D. Berneche, both from the United States Division.</p>
11	Feb. 22/77	<p><i>Canadian Chemical Producers Association—</i></p> <p>Mr. A.J. Foote, Chairman of the Board, Ottawa, Ont.; Major-General Bruce Macdonald, President; and Mr. Chris Conradi, GATT co-ordinator for the Association</p> <p><i>Polysar Limited—</i></p> <p>Mr. Ian Rush, President and Chief Executive Officer; and Mr. Charles McKenzie, Vice-President — Chemicals</p>

Issue No.	Date	Witnesses
11 (cont.)	Feb. 22/77	<i>Du Pont of Canada Ltd.—</i> Mr. Franklin McCarthy, President; Mr. J.H. Childs, Vice-President — Corporate Development; and Mr. A.D. Amery, Senior Economist.
12	Feb. 24/77	Professor Ray Vernon, Director of Centre of International Affairs, Harvard University, U.S.A.
13	Mar. 8/77	<i>Department of External Affairs—</i> The Hon. Donald C. Jamieson, Secretary of State for External Affairs; Mr. Peter Towe, Assistant Under-Secretary of State for External Affairs; and Mr. Patrick Reid, Director General, Bureau of Public Affairs.
14	Mar. 10/77	The Honourable Edward M. Lawson, National Director of Canadian Conference of Teamsters, International Vice-President of the Teamsters Union and the President of the British Columbia Joint Council of Teamsters.
15	Mar. 22/77	<i>Moore Corporation Limited—</i> Mr. David W. Barr, Chairman, Toronto, Ontario; and Mr. Donald S. Dunlop, Treasurer.
16	Mar. 24/77	Professor Lawrence Skeoch, Glenburnie, Ont.
17	Apr. 26/77	<i>Motor Vehicle Manufacturers Association of the United States, Inc.—</i> Mr. William D. Eberle, President and Chief Executive Officer, Washington, D.C.; and Mr. John V. Moller, Manager, International Affairs Department.
18	Apr. 28/77	<i>Science Council of Canada—</i> Mr. John Shepherd, Executive Director; and Mr. Mark Murphy, Researcher.
19	May 10/77	<i>Metric Commission — Canada—</i> Mr. C.M. Bolger, Chairman; and Mr. P.C. Boire, Executive Director.

Issue No.	Date	Witnesses
20	May 12/77	Professor Abraham Rotstein, Massey College, University of Toronto, Toronto, Ontario
21	May 24/77	<i>Travel Industry Association of Canada—</i> Mr. F.G. Brander, President & Chief Executive Officer, Ottawa, Ontario; Mr. Garth C. Campbell, Chairman; and Mr. R.K. Groome, a TIAC Director.
22	May 26/77	<i>Canadian Federation of Independent Business—</i> Mr. John F. Bulloch, President, Toronto, Ontario; and Mr. James R. Conrad, Director, Legislative Affairs.
23	June 7/77	<i>Department of Finance—</i> Mr. Alec Mac Pherson, Director International Eco- nomic Relations Division; and Mr. Lyle Russell, Assistant Director, Tariffs Divi- sion. <i>Department of National Revenue—</i> Mr. T.C. Greig, Assistant Deputy Minister, Customs Program Branch; Mr. A.T. Wickham, Director General, Assessment Directorate; and Mr. Earl Warren, Director General, Anti-Dumping Directorate. <i>Department of Supply and Services—</i> Mr. Craig Oliver, Director General, Supply Plan- ning Sector.
24	June 9/77	<i>Michelin Tires (Canada) Ltd.—</i> Mr. A. Voya Peters, Vice-President, New York City, New York, U.S.A.
25	June 16/77	*

Issue No.	Date	Witnesses
26	July 5/77	<p><i>International Union, United Automobile, Aerospace & Agricultural Implement Workers of America (UAW)</i></p> <p>Mr. Dennis McDermott, Canadian Director, Toronto, Ont. Mr. John Moynahan, President, Canadian UAW Council; and Mr. Samuel Gindin, Research Director.</p> <p><i>United Steelworkers of America, AFL-CIO, CLC—</i></p> <p>Mr. Lynn Williams, Secretary, Pittsburgh, Penn., U.S.A. Mr. Gordon Milling, Canadian Director of Research.</p>
27	July 7/77	<p><i>Canadian Paperworkers Union—</i></p> <p>Mr. L.H. Lorrain, President, Montreal, Quebec; Mr. J.M. Buchanan, Secretary Treasurer; Mr. T.H. Curley, Vice-President of Region 3; and Mr. F.J. Dunberry, Director of Research</p>
28	Aug. 3/77	*

*Note: Issues numbered 25 and 28 dealt with matters not related to the study of Canada – United States Relations.

**Note: This appendix lists the witnesses who testified before the Committee together with the position they held at that time.

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Canada- United States Relations

VOLUME III Canada's Trade Relations with the United States

THE STANDING SENATE COMMITTEE ON FOREIGN AFFAIRS

Chairman: The Honourable George C. van Roggen

Deputy Chairman: The Honourable Martial Asselin, P.C.



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March 1982



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du Canada, Ottawa, Canada K1A 0A4*

Membership of the Committee

The Honourable George C. van Roggen, *Chairman*

The Honourable Martial Asselin, P.C., *Deputy Chairman*

and

The Honourable Senators:

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Bird, Florence B.
Bosa, Peter
Buckwold, Sidney L.
Cameron, Donald
*Flynn, Jacques
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Thompson, Andrew
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Note: The Honourable Senators Royce Frith, Allister Grosart, Earl Hastings, Daniel A. Lang, A. Hamilton McDonald, Robert Muir, Richard J. Stanbury, Arthur Tremblay and David Walker also served on the Committee at various stages.

Order of Reference

Extract from the Minutes of the Proceedings of the Senate, Thursday, May 1st, 1980:

“With leave of the Senate,

The Honourable Senator van Roggen moved, seconded by the Honourable Senator Asselin, P.C.:

That the Standing Senate Committee on Foreign Affairs be authorized to continue its examination of and report upon Canadian relations with the United States;

That the papers and evidence received and taken on the subject in the Twenty-Ninth, Thirtieth and Thirty-first Parliaments be referred to the Committee;

That the Committee be empowered to engage the services of such counsel and technical, clerical and other personnel as may be required for the purpose of the said examination and for the purpose of its examination and consideration of such legislation and other matters as may be referred to it, at such rates of remuneration and reimbursement as the Committee may determine, and to compensate witnesses by reimbursement of travelling and living expenses, if required, in such amount as the Committee may determine; and

That the Committee have power to sit during adjournments of the Senate.

The question being put on the motion, it was—
Resolved in the affirmative.”

Robert Fortier

Clerk of the Senate

Foreword

This report concludes the three-volume study by the Standing Senate Committee on Foreign Affairs on Canada-United States relations. Volume I, presented in December 1975, dealt with the Institutional Framework for the Relationship. Volume II, presented in June 1978, examined Canada's Trade Relations with the United States. The present report, Volume III, continues the study of the trade relationship, building on the conclusions of Volume II.

During the past three years the Committee held some 40 hearings in both Ottawa and Washington, D.C., and heard a range of witnesses, both Canadian and American, including businessmen, labour leaders, academics and provincial and federal officials and Ministers. The Committee wishes to thank all of these witnesses, not only for the time taken by them to appear before the Committee, but also for the time and effort involved in the preparation of the material required for their presentations. Their willing assistance and expert testimony was indispensable in enabling the Committee to arrive at informed opinions as contained in the report although, as is evident from the report itself, each witness will not necessarily concur in all of the conclusions or recommendations herein.

I am most grateful to all members of the Committee and I am especially indebted to my Deputy-Chairman, Senator Martial Asselin, P.C., and to the other members of the Steering Committee for their help and advice. I know that all members of the Committee will wish to join with me in making special reference to Senator Allister Grosart, P.C., the Deputy-Chairman of this Committee from 1969 until his appointment as Speaker of the Senate in 1979. His perceptive questioning of witnesses, his unerring focus on the central issues and his wise counsel have all contributed in an important degree to the Committee's study.

The work of the Committee would have been impossible without the staff support provided by the Parliamentary Centre for Foreign Affairs and Foreign Trade, its Director Mr. Peter Dobell and the Committee's most able staff assistant Mrs. Carol Seaborn, who had the unenviable task of dealing with the Chairman on a day to day basis which she did with unfailing good humour. Assistance was also provided from time to time by the Institute for Research on Public Policy. Mr. Patrick Savoie, the Clerk of the Committee, has been most diligent throughout the hearings and in the production and translation of this report.

An index of the proceedings of the Committee on which this report is based has been prepared by the Reference Branch, Library of Parliament. It is available on request from the Clerk of the Committee.

George C. van Roggen

Chairman

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INTRODUCTION

Recommendations of the Committee's Earlier Report

In 1978 the Senate Committee on Foreign Affairs published the results of its first study of Canada's trading relations with the United States. The report's principal recommendation urged that "governments in Canada, as well as the business and labour communities. . . consider seriously the option of bilateral free trade with the United States."*

During these earlier hearings, evidence was taken from a broad cross-section of Canadian industry. The Committee's focus had been to examine the strengths and weaknesses of Canada's bilateral trade relations with the United States as well as to assess the prospects for the 1980s and 1990s. Among other aspects, it studied the structural problems of much of Canada's manufacturing industry, the effects of the tariff, the imbalance in end products trade, the importance of non-tariff barriers, the low level of research and development (R&D), the high labour costs and low productivity rates relative to the United States prevailing at that time and the future prospects for bilateral trade. The Committee's principal determination was that much of the Canadian manufacturing sector was in a very vulnerable position, shackled with high costs resulting from short production runs and other competitive disadvantages mainly associated with a lack of access to a large tariff-free market.

Disturbed by this finding in an area so critical to Canada's economic welfare, the Committee concluded in 1978 that of all the possible policy responses, the one which showed the most promise was a bilateral free trade

* Canada-United States Relations, Volume II, Canada's Trade Relations with the United States, June 1978.

arrangement with the United States. Aware of the possible political and economic difficulties involved in this conclusion, the Committee recommended an intensive examination of the bilateral free trade idea. The Committee also hoped to provoke a broader public discussion of the future of Canada's trade policy.

New interest in Canada and the United States

The Committee was gratified that its report may have led to some reflection, or at least some thinking out loud, at the senior levels of government. Liberal External Affairs Minister Donald Jamieson remarked that no government would want to dismiss the option of free trade out of hand. Progressive Conservative Finance Minister John Crosbie said free trade with the United States was one of the options Canada should seriously consider over the next few years. A former leader of the Opposition, the Hon. Robert Stanfield, P.C., Q.C. added his voice in speeches during 1979, urging free trade with the United States and stressing the advantages of such a policy in countering regional dissension in Canada. Unfortunately the issue of free trade has not yet been officially addressed or debated by the government.

Nonetheless, the earlier report appears to have coincided with a modest but growing public interest in the subject which resulted in the Committee's Chairman being invited to speak to a variety of groups and associations and to participate in seminars both in Canada and the United States on the subject of bilateral free trade. In part, the report may have provoked discussion and built on an interest latent since the Economic Council Report "Looking Outward" of 1975. In any case it was evident that the report's conclusion evoked far less emotional and nationalist reaction than might have been expected even a few years earlier.

In the United States, part of the impetus for the increasing attention to the subject was provided by Section 1104 of the U.S. Trade Agreements Act of 1979, legislation which provided the statutory basis for U.S. trade relations. Section 1104 required the President to "study the desirability of entering into trade agreements with countries in the northern portion of the western hemisphere to promote the economic growth of the United States and such countries and the mutual expansion of market opportunities". This requirement is an addition to the existing provision (Section 612) of the Trade Act of 1974 which permitted the President to "initiate negotiations for a trade agreement with Canada to establish a free trade area covering the United States and Canada". In 1974 the Section 612 provision was not taken seriously by the Administration since it was a last minute addition to the Bill in Congress with very little discussion. In the 1979 enactment of the Trade Agreements Act, the provisions of Section 612 were repeated, voted on and endorsed by the House Ways and Means Committee. There would thus

appear to be an ongoing Congressional authority given to the President to negotiate a free trade agreement with Canada.

The recent study, mandated by Section 1104 and undertaken by the Office of the Special Trade Representative (STR), itself generated studies by other U.S. agencies such as the study of the petrochemical industry undertaken by the International Trade Commission for the STR. In Congress, the Subcommittee on International Trade of the Senate Finance Committee held hearings on North American trade during 1979 and 1980. A number of private groups including the U.S. Chamber of Commerce, the U.S. United Nations Association and the Canadian-American Committee undertook studies in this area.

Further stimulus to the idea in the United States was sparked by the 'North American accord' statement of President (then Governor) Reagan in the November 1979 announcement of his candidacy for the presidency. At the time he said:

"a developing closeness among Canada, Mexico and the United States—a North American accord—would permit achievement of that potential in each country beyond that which . . . any of them . . . could accomplish in the absence of such co-operation."

Other prominent U.S. political figures including presidential aspirants Kennedy, Connally and Brown simultaneously endorsed the 'trilateralism' concept, frequently conceiving of it as a North American resource-based or energy common market.

It was the continental energy thrust to the 'accord' proposal which undoubtedly contributed to the negative reactions from both neighbours. In a joint statement in May 1980, Prime Minister Trudeau and the Mexican President Mr. Lopez Portillo firmly distanced themselves from the trilateral concept, stating that "such an approach would not serve the best interests of their countries", Mr. Trudeau adding that Canada's interest "would be advanced by the continuing strengthening of bilateral relations with Mexico and the United States."

Meanwhile cautious discussion of the idea of bilateral free trade was taking place in Canada. In 1979 a nation-wide poll conducted by a national magazine found that two out of three Canadians favoured free trade with the United States. The strongest support came from the Maritimes and the West but a majority of those polled in every region backed the idea. It was evident that the subject was no longer taboo. In industry, the government-inspired sector task force studies showed that seven out of twenty-three sectors, including petrochemicals, urban transportation equipment, electronics and cement spoke positively about bilateral free trade for their products. Statements supporting the idea were also increasingly heard from certain Canadian producers as they recognized their longer term need for free access to a larger market.

Canada's trade and payments position—an update

In its 1978 report, the Committee drew attention to the basic facts of Canada's international trade situation as well as a more detailed analysis of the Canada-U.S. trade picture. It underlined then, and it does so again, that because of the enormous concentration of Canadian trade with the United States involving all sectors of the economy, the state of Canada-U.S. relations has a critical bearing on Canadian commercial and economic policy and on its international trade prospects as well.

On the surface, Canada's international trade situation actually looks fairly good. Despite an international recession when exports usually fall faster than imports, Canada has done well in world trade, finishing with a large surplus of \$5.2 billion in 1980 and a lower but still significant surplus of \$2.3 billion in 1981.

Looking more closely, one is faced with more sobering facts. The main reason for Canada's good overall trade performance in 1980 lay in the exports of crude and fabricated materials, commodities such as forest products, grains, natural gas and mineral products. The value of forest products exports alone was \$12.8 billion and the value of wheat exports nearly doubled in 1980 to a record \$4.1 billion. Minerals and natural gas produced a \$5 billion export surplus in these commodities. But in the end product, manufacturing sector which employs 2 million Canadians and pays \$23 billion in wages, the same old problems remain. For end products, the 1980 deficit in Canada's world-wide trade balance was over \$17 billion. This situation became even more worrying in 1981 when the value of imported end products rose much faster than the value of Canada's end product exports. The result was a huge \$20 billion deficit in Canada's end product trade.

In respect to Canada-U.S. trade only, by 1981, the value of goods trading across the border had reached \$100 billion, considerably more than between any two other countries in the world. In that year over 68 percent of Canada's total trade was with the United States (66 percent of its exports and 68 percent of its imports). The enormous flows back and forth across the border were almost in balance with a small surplus of \$1.2 billion in favour of Canada. Again, on looking closely, a strong surplus for Canada is evident in crude materials and fabricated materials trade with the United States, adding up to almost \$16 billion more in exports than in imports. But despite the advantage of depreciated dollar which assisted the competitiveness of Canadian products in U.S. markets, Canada's bilateral deficit in end product trade with United States has continued to rise, reaching over \$15 billion in 1981. This widening imbalance occurred despite a lessening in Canada's deficit in bilateral automotive trade from \$3 billion in 1979 to \$2 billion in 1980 and to \$1.8 billion in 1981.*

*Figures for 1981 are preliminary only.

Table 1

Canada's Merchandise Trade, 1978-81
(billions of Cdn. dollars)

		Crude Materials	Fabricated Materials	End Products	Total Merch' Trade
Trade with all countries:					
1978	Exports	8.8	19.2	18.9	52.3
	Imports	<u>5.9</u>	<u>8.7</u>	<u>31.3</u>	<u>50.1</u>
	Balance	2.9	10.5	-12.3	2.2
1979	Exports	12.5	24.4	20.8	64.2
	Imports	<u>7.9</u>	<u>12.1</u>	<u>37.9</u>	<u>62.7</u>
	Balance	4.6	12.3	-17.1	1.5
1980	Exports	14.8	29.3	21.7	74.2
	Imports	<u>11.3</u>	<u>12.7</u>	<u>39.5</u>	<u>69.0</u>
	Balance	3.5	16.6	-17.8	5.2
1981*	Exports	15.2	30.5	25.1	83.7
	Imports	<u>12.1</u>	<u>14.5</u>	<u>45.8</u>	<u>78.9</u>
	Balance	3.1	16.0	-20.7	4.8
Trade with United States:					
1978	Exports	5.5	13.8	15.8	36.7
	Imports	<u>2.4</u>	<u>6.1</u>	<u>24.9</u>	<u>35.4</u>
	Balance	3.1	7.7	-9.0	1.3
1979	Exports	7.6	17.0	16.9	43.4
	Imports	<u>3.7</u>	<u>8.7</u>	<u>30.4</u>	<u>45.4</u>
	Balance	3.9	8.3	-13.5	-2.0
1980	Exports	9.1	18.8	16.7	46.8
	Imports	<u>5.1</u>	<u>9.2</u>	<u>31.0</u>	<u>48.4</u>
	Balance	4.0	9.6	-14.3	-1.6
1981*	Exports	9.2	21.5	20.1	55.5
	Imports	<u>4.5</u>	<u>10.3</u>	<u>35.8</u>	<u>54.3</u>
	Balance	4.7	11.2	-15.7	1.2

Sources: *Imports by Countries*, Jan.—Dec. 1980, Statistics Canada, p. 13, *Exports by Countries*, Jan.—Dec. 1980, Statistics Canada, p. 19. Statistics Canada *Daily*, 3 February 1982. *The detailed figures for 1981 are preliminary only; Statistics Canada, *Catalogue 65-001*, 1982.

Nor has the problem of Canada's perennial current account deficit disappeared. Even with Canada's recent surpluses in its world merchandise trade account, its overall current account has remained in deficit, averaging over \$4 billion during the past five years, due to the very serious imbalance in invisible or service trade items (travel, dividends, insurance, freight charges, etc.)*. In 1980, this invisible deficit reached \$9 billion, most of it with the United States. As a result, Canada's bilateral current account deficit with

*Preliminary figures for 1981 show a record high current account deficit of over \$6 billion.

that country has expanded from \$3.5 billion in 1975 to over \$8 billion in 1980, the recent deterioration caused mainly by a rapid rise in interest payments resulting from extensive corporate and governmental borrowing combined with the depreciation of the Canadian dollar. Little improvement is seen in the bilateral travel account, a component of the invisibles account. Despite predictions for considerable gains, Canada's bilateral travel account deficit with the United States stood at \$800 million in 1980.

Table 2

Canada's Current Account Deficit with the United States
(Billions of Cdn. dollars)

	1976	1977	1978	1979	1980
Current Receipts					
Merchandise exports	25.7	31.0	37.1	44.6	48.5
Invisible earnings	4.2	4.6	5.3	5.9	6.6
Total current receipts	29.8 ¹	35.7 ¹	42.4	50.4	55.1
Current Payments					
Merchandise imports	25.1	29.3	34.9	44.4	47.7
Invisible payments	8.7	10.2	12.3	13.8	15.6
Total current payments	33.8	39.6 ¹	47.2	58.2	63.3
Current Account Balance	-4.0	-3.9	-4.7 ¹	-7.8	-8.2

¹Figures may not add exactly due to rounding.

Sources: 1976 & 1977 figures—Canadian Balance of International Payments, 1977, Statistics Canada, p. 53; 1978, 1979 & 1980 figures—Quarterly estimates of Canadian balance of international payments, Fourth Quarter 1980, Statistics Canada, pp. 46-7.

As for investment, Canadians now invest more outside Canada than foreigners invest in Canada, a remarkable change from the earlier 1970s. By 1978, Canadian direct investment in the United States accounted for more than half the total and amounted to \$9 billion by 1978, up from \$6 billion in 1976. U.S. direct investment in Canada, valued at \$31.9 billion in 1976, grew relatively more slowly to \$38.3 billion. More than half the outflow of Canadian direct investment capital can be accounted for by the manufacturing industry, such investments reflecting in part at least the desire, particularly of smaller manufacturers, to have access to a larger market.

The international scene revisited

A renewed scrutiny of the current world trading environment is not a reassuring exercise in terms of Canada's trading prospects. True that the Tokyo Round multilateral trade negotiations made progress in liberalizing

trade among member states of the GATT (the General Agreement on Tariffs and Trade). Tariff reductions of an average range of 35 percent are likely to result in increased export opportunities as long as non-tariff measures do not intrude. But, in another respect, the trading opportunities have become more constricted. The European Community (EC), originally consisting of six member countries, has now expanded to 10 countries with prospects of growing to 12 shortly. When account is taken of the EC's free trade agreements with the remaining EFTA countries, this means that virtually all of Western Europe is organized into a preferential free trade unit for industrial products. As for Japan, its continued growth and success as a major trading power has astounded and jolted the other industrialized trading countries. In effect, these developments have meant a strengthening, relative to North America, of the two most powerful trading units each with free access to large internal markets. They are not encouraging for Canadian manufactured exports and it may actually negate much of the liberalizing effect of the Tokyo Round tariff reductions. Simultaneously, a New Protectionism appears to be emerging, with the governments of trading countries giving high priority to internal economic demands. While vocally supporting trade liberalization, they frequently undermine it in practice by implementing a host of non-tariff barriers.

Competition from developing nations is also part of the problem for Canada's manufacturing sector as countries such as South Korea, Hong Kong, Singapore, Brazil, Mexico and Taiwan step up their exports of manufactured items. With considerably lower labour costs, these newly industrialized countries (NIC's) can pour out standard technology items and transport them into markets around the world at a fraction of the Canadian cost of production. Against such products, the average Canadian tariff offers no meaningful protection.

The exchange rate plays a major role in shaping Canadian trade patterns. After 1976 and until the end of December 1980 the Canadian dollar experienced a substantial depreciation relative to most other currencies. Against the currencies of the major industrialized countries of Western Europe and Japan, the Canadian dollar declined by 37 percent in this period, a major factor in the improved sale of Canadian goods to Western Europe in 1979 and 1980 and in the slowing down of imports. Vis-à-vis the United States dollar, Canadian currency declined 18 percent over this period, a development which improved the competitive position for exports to the United States. However, from mid-1980 to mid-1981 the Canadian dollar strengthened against Western European currencies, rising 15 percent against the British pound, 24 percent against the French franc, 23 percent against the West German mark and 18 percent against the Swiss franc, changes which have again made this market difficult for sales. Over the same time period, the dollar has continued to decline against the U.S. dollar, depreciat-

ing 6 percent, and has remained almost static with respect to the Japanese yen. These exchange rate changes make the United States, more than ever, the market into which Canada is best placed to export.

* * *

The Committee's earlier study of Canada's trade relations with the United States had taken place against a background of ongoing multilateral trade negotiations under the GATT. During Committee hearings it was evident that the GATT Tokyo Round negotiations generated a considerable nervousness among industry witnesses as to how the outcome of negotiations would affect them, conscious as they were of their competitive disadvantage. Commenting in 1978 on the possible outcome of these negotiations, the Committee was somewhat doubtful that the negotiators could achieve their objectives in tariff reductions or whether meaningful restrictions could be placed on non-tariff measures.

As it turned out, from a multilateral point of view, the Tokyo Round achievements in liberalizing international trade, specifically the gradual implementation of a 35 percent reduction in average rates of duty, may be substantial. From the point of view of Canadian industry, however, the overall impact of the GATT negotiations may not be so positive. Particular problems are emerging in respect to Canada-U.S. trade.

PART I

A. The Situation Facing Canadian Industry

1. Results for Canada of the Multilateral Trade Negotiations

After six years of hard bargaining, the GATT Tokyo Round multilateral trade negotiations (MTN) were completed in 1979. Few countries had more at stake in the outcome than Canada. Few countries have a larger range of exportable goods. Few countries have exports that constitute a higher percentage of gross domestic product (GDP) than does Canada, where it amounts to about 26 percent. Under the 1979 GATT agreement, a framework was set which will significantly affect Canada's international trade opportunities during the 1980s and well into the 1990s. Both the level of tariff protection and the use of non-tariff measures are affected.

In terms of Canada-U.S. trade, the Committee was told by officials of the Department of Industry, Trade and Commerce that when the Tokyo Round tariff reductions are fully implemented by January 1987, 80 percent of current Canadian industrial exports to the United States will actually enter duty free and up to 95 percent will be subject to tariffs of 5 percent or less. For U.S. exports to Canada, the comparable figures will be 65 percent entering duty free and another 26 percent entering at rates of 5 percent or less.

a) *Tariffs*

Under the Tokyo Round agreement, Canadian tariffs will be cut by close to 40 percent. Canada's major trading partners, the United States, the Euro-

pean Community and Japan agreed to make comparable or somewhat smaller reductions. U.S. tariffs on more than \$4 billion worth of Canadian non-agricultural exports will fall by an average of close to 40 percent; the European Community will make tariff reductions averaging about 30 percent affecting over \$1 billion worth of Canadian industrial exports and Japan will cut its tariffs by about 31 percent on \$800 million worth of exported Canadian industrial products. The reductions, to be staged in eight annual steps, began on 1 January 1980 and will be completed on 1 January 1987.

Canada may have entered the negotiations at somewhat of a disadvantage, partly because it was perceived by other major industrialized countries as having had a 'free ride' in the Kennedy Round GATT talks in 1967, and partly because Canadian tariffs were seen to be relatively high—in the 15 percent or higher range—even though many imports including sophisticated machinery not made in Canada entered duty free. By the time the agreement is fully implemented, the average rate of Canadian tariffs on industrial imports will have been lowered from 15 to between 9 and 10 percent. While this rate is high relative to the average 4 to 5 percent U.S. rate and the 6 percent rate in both Japan and the European Community, the comparative adjustment requirement, in tariff terms, will be greater. In effect, Canada's reductions represent a loss of about 5 percent in protection compared to 2 to 3 points by the other major trading countries. Looked at positively, the tariff reductions will result in lower costs of inputs for Canadian industries as well as lower costs for a broad range of consumer goods. Canada agreed to make formula reductions in the range of 30 to 40 percent on most consumer items. But Canada, like other major MTN participants, made no significant reductions in its tariff protection on textiles, clothing and footwear although some protection on footwear has been removed during 1981. While lower U.S. tariffs on dutiable forest products should stimulate exports across the border, a number of other processed resource products did not fare so well. The Canadian petrochemical industry made few gains and the U.S. tariff will actually be higher on some petrochemical derivatives.

In sum, for Canada, there are losses as well as gains, minuses as well as pluses from the Tokyo Round liberalization of tariffs. (For a more detailed analysis of the results of the Tokyo Round, see Appendix A.)

b) Free trade in civil aircraft

A major international free trade agreement was concluded at the Tokyo Round which has been hailed as a possible prototype for future agreements in other sectors. The Agreement on Trade in Civil Aircraft entered into initially by Canada, the United States, the EC, Japan and Sweden provided for the mutual elimination as of 1 January, 1980 of all duties on civil aircraft and the repair of such aircraft plus the removal of duties on between 85 to 90 per-

cent of trade in components of civil aircraft including avionics and flight simulators. As well as tariffs, the agreement restricts certain non-tariff measures including government procurement and national treatment. These non-tariff concessions, based on the principle of 'conditional' most-favoured-nation (MFN) treatment, are available to other GATT signatory countries which agree to make similar concessions.

The civil aircraft free trade agreement will enhance Canada's export opportunities to a number of countries, including the United States, for high technology aerospace products.

c) Non-tariff barrier codes

The Tokyo Round marked the first time that GATT multilateral trade negotiations endeavoured to deal with non-tariff measures in detail. In the face of the increasing use of such devices, the task to bring them under better control was formidable. Some progress was made and the codes of conduct on non-tariff measures, although very limited, have established a pattern for their regulation in the future. However, enforcement of the codes may prove difficult on a multilateral basis. Such enforcement is in the hands of committees of GATT nations and sub-committees of technical experts and these bodies will require time and experience before they can prove their effectiveness.

More specifically, no agreement was reached in Geneva on new safeguard rules on emergency action against intolerable, but 'fair', import competition, a distinct shortcoming from the Canadian point of view. The agreement on government procurement, while technically well set out, has proved a major disappointment to Canada because of its very limited coverage. The agreement on valuation will establish uniform rules to be applied by all governments in determining the value of imported goods for customs purposes, based on the 'transaction value' of the goods. Implementation of this agreement will be generally difficult for Canada which has operated under a radically different valuation system based on the price charged in the home market of the exporter. (See Appendix A for more details of the problems for Canada related to the GATT non-tariff codes).

2. U.S. non-tariff barriers affecting Canada-U.S. trade

In the context of Canada-U.S. trade, as distinct from multilateral trade, the impact of non-tariff barriers is increasing both relatively and absolutely. This reflects both the diminishing importance of tariffs and the growing recourse to non-tariff barriers as a form of protection.

The Committee heard evidence that serious non-tariff problems with the United States are likely to arise in the following areas: countervail, procure-

ment and customs valuation; U.S. safeguard actions applied inadvertently against Canadian exports; and the complex trade regulatory system spelled out in the 1979 Trade Agreements Act. In addition, DISC is a perennial non-tariff irritant.

Countervail

In respect to countervail, Mr. Rodney Grey, the former head of the Canadian delegation to the Tokyo Round, and Professor Fred Lazar of York University and Director of the Canadian Institute for Economic Policy have pointed out that the GATT agreement leaves a number of problems vis-à-vis the United States. First, although the U.S. government must now establish injury prior to imposing countervail duties, new U.S. procedure makes it easier for U.S. companies to lodge complaints and for the authorities to find 'injury'.

Secondly, as Mr. Grey emphasized a vigorously applied U.S. countervail system could have an inequitably heavier impact on the effectiveness of Canadian industrial development policies when contrasted to any parallel countervail action Canada could take against the United States. This is because such a relatively large percentage of Canadian production is exported while in the United States the major portion of production is for the internal market. Any subsidization of Canadian industry could be seen as involving an encouragement of production for export purposes and would accordingly run the risk of U.S. countervail. By contrast, subsidization of a firm in the United States would be directed mainly toward encouraging production for the U.S. domestic market and would only involve the risk of a Canadian countervail for the very small percent of products which it might export.

Third, in the GATT agreement many anomalies in what constitutes a subsidy for countervail purposes remain. For instance a DREE subsidy, although not inconsistent with the GATT code, appears to be subject to countervail. But general tax incentives or the provision by states or provinces of required infrastructure for industrial sites may not be vulnerable. Finally, the United States, in a move directed at the European Community and not at Canada, has changed its 'offsetting' rule by which the amount of the subsidy to be countervailed could be reduced by the extra amount involved in locating a plant in less than a prime location. According to Mr. Grey, this could make U.S. countervail even more threatening than before the Tokyo Round. The earlier U.S. procedure took into account that regional development grants are legitimate policies. Mr. Grey expressed the opinion that if it were possible to persuade the United States to change the 'offsetting' rule, it would be in the common interest of both countries and a bilateral agreement could be made without raising problems at the GATT.

It will be necessary for the Canadian government to negotiate bilaterally with the United States concerning countervail, specifically stressing the uneven impact of application of countervail on the two countries, the need for an agreement on what constitutes a permissible subsidy and the possibility of the United States using the 'offsetting' technique in respect to Canada.

Procurement

Procurement is the most pressing non-tariff barrier problem Canada currently has with the United States. By virtue of its geography, its economy, its requirements for national survival, Canada has developed an excellence in products such as telecommunications equipment, electricity generating and transmitting equipment, urban mass transit equipment, aircraft and aircraft parts and avionics, products which are almost always purchased by governments or their agencies. Without a domestic mass market base, the survival of these Canadian industries depends on sales to foreign procurement markets, mainly those in the United States. Yet with the exception of civil aircraft and aircraft parts, it was precisely these areas which the GATT procurement agreement failed to open up. Mr. Rodney Grey warned the Committee that the code's coverage is so limited "it may just collapse if it is not extended."

Not only did the procurement code not succeed in opening up these markets but there was a marked increase, even while the GATT negotiations were proceeding, in U.S. procurement protection mandated by Congress and at the state level. The recent proliferation of state Buy American laws and regulations has brought to 37 the total number of states with such restrictions. Congress passed the Surface Transportation Assistance Act in 1978 and has tied Buy American restrictions to other federal appropriations laws such as the Public Works Employment Act or the Clean Water Act. Under such legislation, state or local governments receiving federal funds for financing projects are required to apply Buy American restrictions to such projects. In practice, this means that more than 50 percent of the content must be American and that the final assembly take place in the United States. An even more stringent proposal to raise the content requirement from 50 to 70 percent is currently being pushed in Congress and at the state level. In addition, some states have passed their own procurement laws and regulations specifying a level of domestic preference which may range as high as 20 percent.

Such U.S. legislative actions have hit certain Canadian producers hard, particularly the Buy American provisions under the Surface Transportation Assistance Act. For example, in the structural steel sector, steel bridge exports to New York State alone fell from \$20 million in 1978 to \$1 million in 1979. Mr. Raymond Royer of Bombardier Inc. told the Committee that

the 1978 extension of the Buy American laws had hit his company just as it had expanded its urban transit equipment operations and was beginning to market in the United States. The company decided it had no alternative but to establish facilities within the United States if it wanted to circumvent state Buy American barriers to municipal markets. Mr. Ron McCallum of Hawker Siddeley Canada warned that if the 50 percent requirement for basic U.S. content were to be raised to 70 percent, it would lead to complete manufacture of his company's urban transit cars in the United States.

It is urgent that the Canadian government should deal with this situation. In the urban transit sector alone, the U.S. market is estimated at a possible \$5 billion within the next five years. Canadian producers are being obliged to establish facilities in the United States to circumvent the procurement restrictions.

Canada cannot afford to wait for further multilateral negotiations on procurement. Mr. Grey made the point that Canada could have done much better at the GATT negotiations if it had been negotiating bilaterally with the United States rather than multilaterally. The Hon. Larry Grossman, Ontario Minister of Industry and Tourism added that the U.S. Surface Transportation Assistance Act had been put in place "basically to lock out Japanese competition . . . because the Americans could not get access to the growing Japanese market."

The basis already exists for bilateral initiatives. The United States has declared itself ready for reciprocity in the Trade Agreements Act of 1979, and has made it clear that it would accord better access to its procurement market to those who offered American producers better access to their markets. In this respect, Canada undoubtedly qualifies since at least 20 percent of goods purchased by the Canadian federal government annually are from foreign, mainly U.S., suppliers. This record is more favourable, in relative terms, than even that of the United States which is considered more open in its procurement purchasing than most other countries.

Mr. Grey suggested to the Committee that the government seek a bilateral deal on procurement by which the United States would exempt Canada from the provisions of the Buy American Act. (See Appendix A for details of his proposal) However, the Committee notes that the Canadian government has twice had discussions—in 1977 and 1980—with the U.S. Administration on procurement under the Surface Transportation Assistance Act. It had no success in obtaining a procurement arrangement for Canada. Canada currently lacks a good bargaining position and its position is being made weaker by the fact that Canadian firms are establishing plants in the United States. Moreover, it is doubtful that, even if Canada convinced the U.S. Administration to agree to a waiver for Canada from the restrictive legislation, the Administration would find it easy or possible to persuade Congress to pass

the necessary amendments to exempt, specifically and exclusively, only *Canadian* exporters. Furthermore, solving the federally-controlled non-tariff barriers would not be the only problem. Downstream from that, as business witnesses pointed out, problems would emerge such as limitation on technical specifications, preferences at a local level, labour objections, and all kinds of lobbying.

Mr. Kirk Foley of the Urban Transportation Development Corporation proposed to the Committee that Canada and the United States might enter into a joint venture in urban transit products which would allow manufacture of equipment in both countries and permit Canadian producers to circumvent U.S. Buy American rules. He compared it to the Canadian participation in the U.S. space program. The idea could have advantages for Canada but it is not evident to the Committee why it should prove particularly attractive to the United States.

The issue of U.S. procurement barriers is a pressing one for Canada and will require negotiations and resolution on a bilateral rather than a multilateral basis. What is needed is a procurement arrangement between Canada and the United States which would put this country in a special category vis-à-vis the United States.

Customs valuation

Potentially, Mr. Grey told the Committee, customs valuation could be one of the most troublesome areas for Canada emerging from the Tokyo Round. Canada and the United States were the only two major trading countries at the Geneva negotiations which were not previously using the GATT system of valuation. Canada agreed to the GATT Customs Valuation Code with great reluctance as it will require drastic adjustments in its present system. The switch by the United States to the new system is likely to cause Canada problems arising from the possibility of excessive use of U.S. administrative procedures; from the use of artificially low transfer prices in transactions between related companies; and from the issue of inland freight charges. The fact that the GATT code failed to deal adequately with the issue of the artificially low transfer prices for duty valuation purposes may prove particularly troublesome to Canada and the United States in view of the very large amount of trade between subsidiary and parent companies. Finally, the revisions in previous U.S. *ad valorem* rates on specific products, such as petrochemical derivatives, are likely to impede Canadian exports, since the effect of the revisions will be to raise the effective tariff barrier on a number of these items.

It is not easy to see how many of the custom valuation problems between Canada and the United States can be settled unless the two parties bring to

negotiations a determination that particular conditions in the North American trading context warrant special bilateral arrangements to resolve them.

DISC

Since 1971 the United States has used the export subsidization device DISC, the Domestic Sales International Corporation, to stimulate exports and retain direct investment in the United States. The system grants tax incentives in the form of a deferral of taxes on income from exports to companies operating in the United States. Not only does a DISC scheme give an advantage to the U.S. company competing in the Canadian market, but it has the additional impact of influencing the production decisions of U.S. multinationals in favour of their plants located in the United States as opposed to their Canadian subsidiaries.

The Tokyo Round agreement prohibited such export subsidy schemes as the DISC, but a proviso was accepted that any signatory country was only required to make a "reasonable effort" to overcome an obstacle such as Congressional resistance. The Tokyo Round will not, therefore, result in the termination of DISC by the United States, particularly since the Reagan Administration appears ready to challenge EC Commission officials on tax-based subsidies of EC member countries.

The Committee sees the DISC as another area where Canada is inadvertently affected by U.S. policies when it is not the target. While DISC is not a major irritant, **Canada should make an effort to come to an arrangement with the United States on a bilateral basis respecting it.**

Other U.S. non-tariff measures

Another problem to which Mr. Grey drew attention was the vulnerability of Canadian exports to U.S. safeguard or emergency actions. Especially in times of an economic downturn, businessmen are more likely to seek increased protection from some sort of emergency import action. The difficulty is that, because of the non-discrimination rule of the GATT, Canada is liable to be hit unjustifiably when the United States takes action against unfair or intolerable imports from other trading partners. Examples of past U.S. punitive action hitting Canada inadvertently are U.S. safeguard measures against specialty steel and fasteners in 1974 and 1978.

Finally, Mr. Grey emphasized that there had been a fundamental change of approach in the United States in recent years which was not at all reassuring for future Canada-United States trade relations. Parallel to its agreement to lower certain tariff rates in the 1980s, the United States has taken action to protect its imports by refining its various legal mechanisms to deal with import competition. A complex regulatory system has been developed over a

number of years and has been given full expression in the 1979 Trade Agreements Act. This new emphasis in the United States on what Mr. Grey has called a system of contingent or stand-by protection, means that U.S. domestic producers will be able to get protection when a case can be made for it. Mr. Grey suggested in a recent article that despite diminishing tariffs resulting from the Tokyo Round, the United States has not effectively lowered its barriers to imports as a result of the multilateral trade negotiations. He emphasized that, for Canada, the important objective would be "getting inside, rather than staying outside, the whole legalistic trade regulatory system now installed in Washington, D.C."

In sum, in its trade with the United States, Canada faces a strengthened array of non-tariff barriers. The GATT multilateral negotiations have failed to resolve these problems.

The Committee is convinced that the only way to deal with these problems—procurement, countervail, customs valuations, DISC, and safeguard restrictions—is through bilateral negotiations with the United States. The only way to get inside the new, potentially protectionist U.S. trade regulatory system is through a bilateral arrangement with the United States.

3. The implications of the Tokyo Round for Canadian industry

"Time is not on the side of this country's manufacturing industry," wrote the Economic Council in 1975. The prospects have not been greatly improved by the completion of the Tokyo Round negotiations, and in a number of respects the outlook is less promising than before.

In sectors where the traditional tariff protection is diminishing, increased import competition from efficient foreign producers will challenge the less-protected Canadian manufacturers who are not structured to resist such competition and whose position will be gradually eroded. At the same time, many Canadian manufacturers will not be in a position to take advantage of the increased export opportunities in the U.S. market, also less protected by tariffs. In that market they will face stepped-up competition as stronger, more efficiently structured Japanese or European competitors move in. At the same time, relatively high U.S. duties will remain on a number of items of importance to Canadian industry, most notably on petrochemicals where Canadian producers stand ready to compete internationally.

In the trading world of the 1980s, tariffs are no longer the most important influence on trade flows for most products. Much more worrying in the Canada-U.S. context are the unresolved problems related to non-tariff restrictions and particularly the U.S. non-tariff barriers spelled out above. The economic distortions to trade which arise from such non-tariff restrictions may prove to be more costly than any remaining tariffs. They could

result in higher prices, in misallocation of resources, in restricted choices, in inferior products and in the location in the United States, instead of in Canada, of important high technology producers.

The Tokyo Round has, in effect, left Canadian industry in the worst of both possible worlds—with tariffs too low to be an effective protection and, at the same time, still without free access to a huge assured market as enjoyed by its competitors, the European Community, Japan and the United States.

4. The outlook for Canadian industry

In the 10 year period to 1979, Canada's share of world trade in manufactured goods declined from 4.8 percent to 3.1 percent. Canada's trading performance world-wide and with the United States has, at best, marked time since the Committee completed its last report in 1978. In spite of strenuous efforts by the government, to be briefly reviewed in the next section, and the completion of the MTN, the deficit in end product trade continues to grow. Canada appears to be in danger of being pushed out of world markets in manufactured goods.

The problem remains, as the Committee pointed out in its earlier report, that too many fragmented and inefficient firms are producing mainly for the small Canadian market. It is important to observe that Canada is the only major industrialized country without free access to a market of from 100 to 300 million people. The manufacturing sector is, with a number of notable exceptions, producing standard technology products, using technology which has been largely imported. A high proportion (over 50 percent) of the sector is foreign-owned. R&D in Canada has been at seriously low levels. Productivity is rising relatively more slowly in Canada than in competing countries and remains markedly lower than in the United States.

The remedies are generally accepted and not particularly controversial: economies of scale are essential; the Canadian manufacturing sector must rationalize; it must specialize in particular product lines instead of a broad diversity of products; it must modernize its production processes and achieve economies of scale and higher productivity rates through long, efficient production runs; it must seek out the areas where Canada has natural advantages.

Where opinions differ is on how to accomplish these changes.

B. Actions So Far . . . And Reactions

1. Government actions

Recognizing the basic weakness in much of the Canadian manufacturing sector and its increased vulnerability in the wake of the Tokyo Round, the government has been implementing in recent years certain policies designed to stimulate and assist the necessary restructuring of this sector and to increase Canadian competitiveness.

The government has sought to gain a larger market for Canadian products through a variety of policy modifications and programs. These include an emphasis on increasing domestic import displacement through 'Shop Canadian' programs and a monitoring process on purchases in megaprojects; an emphasis on domestic sourcing under the National Energy Program (NEP); a variety of industry development programs including the Defence Industry Program (DIP) and the Enterprise Development Program (EDP); and a policy of nurturing selected high technology sectors; a review of procedures under the Foreign Investment Review Agency (FIRA) coupled with what appears to the United States to be a stronger emphasis on the "significant benefit to Canada" requirement; and a drive to co-ordinate not only federal procurement but certain provincial procurement as well as a way of promoting the restructuring of Canadian industrial sectors.

In addition, in January 1981, a special industrial and labour adjustment fund of \$350 million was announced which, over the next three years will help displaced workers and assist communities which are particularly hard hit by industrial readjustment. Special measures have been announced for the textile and footwear industry. (See Appendix B for a more detailed examination of the government's industrial development program.)

It may be premature to assess the results of certain of these measures since they have only recently been introduced. But it is clear that the strategy of 'picking winners' in the high technology sector, for example, has had mixed results. And the Committee notes that many of the measures represent extensions of policies already in place for a number of years, which have thus far failed to bring about the intended broad restructuring of Canadian industry.

2. U.S. reactions to Canadian industrial development policies

After carefully watching Ottawa's recent economic policy directions, Washington has cried "foul play!" During 1981 the U.S. Administration has publicly called for changes in FIRA's Canadian benefit requirements, in Canada's duty-remission plans to foster exports and in what are perceived to be the trade distorting effects on the sourcing of goods, equipment and ser-

vices under the NEP. Specific Congressional hearings devoted to Canada's 'discriminatory' policies have raised calls for tough measures including a moratorium on Canadian investment in U.S. companies, tougher financing rules for Canadian companies and the exclusion of Canadian energy firms from holding mineral leases on U.S. federal lands. The U.S. Administration has set up a task force under the Office of the Trade Representative and the Commerce Department, aimed at finding effective means of pressuring Canada to change its policies.

In addition, the Administration has been strongly critical of proposed changes in Canada's import policy and it is watching closely the way Canada will handle its eventual adherence to the customs valuation code as well as the extent to which procurement preferences are being used by Ottawa to encourage high technology industries.

There is no doubt that the United States may try to retaliate in a number of damaging ways. Under the U.S. Trade Act of 1974, the President is authorized specifically to retaliate against any country that "engages in discriminatory . . . policies . . . which burden or restrict United States' commerce". Such measures might include import duties or restrictions directed specifically against Canada, an expanded use of the 'trigger price' mechanism for Canadian steel imports, or tougher conditions for Canadian banks operating in the United States or a move against forestry exports, Canada's largest earner of foreign exchange.

Reviewing these developments, the Committee is alarmed that Canadian industrial development policies are not only failing to achieve a restructuring of industry in this country, but they are also causing Canada to become a target for the U.S. Administration, for Congress and for an influential segment of the private business sector.

The Committee is concerned that the reaction of both government and industry in the United States to Canadian policies is not being adequately considered by Ottawa. Given the high degree of interdependence existing between the two countries, Canadian industrial development policies can have negative consequences for U.S. industries. Affected U.S. firms may demand that the U.S. Administration and Congress provide relief. Bilateral trade confrontations seem bound to increase and Congress, in particular, may retaliate in quite unrelated areas as it has done in the past. The Canadian economy could end up in a very much worse situation than would have occurred without some of these Canadian government's industrial development measures.

It is in light of these concerns that the Committee considers it more urgent than ever to draw attention to an alternative policy course.

PART II

A. An Alternative Approach

As already stated in its earlier study, the Committee was concerned over the competitive disadvantages of Canadian industry, particularly in the manufacturing sector. In its 1978 report, it reviewed the industrial development measures which the government had taken at that time and made a number of its own recommendations for strengthening Canada's competitive capacity. The Committee concluded then that such measures by themselves would not be enough to achieve the necessary restructuring of the manufacturing sector. Nor would they ensure the necessary access, particularly over U.S. non-tariff measures, to the U.S. market. The main recommendation of the 1978 report was to urge that the idea of a bilateral free trade arrangement with the United States be seriously studied.

Regrettably, as far as the Committee is aware, the government has attempted no analysis of bilateral free trade between Canada and the United States and its policy thrust has continued to incline in the opposite direction. Instead, the government has continued to strengthen existing programs designed to stimulate industrial development including those to encourage displacement of imports, those to spur high technology exports or those to organize a co-ordinated Canadian procurement market or those to strengthen FIRA.

The perception of the critical importance of a large market has been borne out by representatives from various Canadian manufacturing indus-

tries at the Committee's recent meetings. Companies which have good access to the U.S. market, such as is available for aerospace and related products under the new GATT agreement for trade in this sector, are successfully exporting to the United States. In certain other industrial sectors, some large companies, including Canadian subsidiaries of multinationals, are already rationalizing and are gaining access to U.S. markets for specialized products through internal arrangements such as world product mandates. But many Canadian companies, lacking this opportunity, are struggling with the restructuring problem without the guaranteed market access. A growing number of these Canadian companies rather than increasing investment in Canada, are buying into U.S. markets through acquisitions in order to gain assured access. (Canadian direct investment in the United States increased by 43 percent in 1980 over 1979, mostly through U.S. affiliates of Canadian companies). Still other Canadian companies, unfortunately, seem prepared to rely on various government industrial policies to do their restructuring for them or are seeking continued protection from tariffs or quotas or non-tariff measures.

The Committee remains convinced that what Canadian industry needs, above all else, is dependable access to the U.S. market, and better still, a preference in that market over both the advanced industrial countries of Europe and Japan and the fast-growing NICs. Canadian industry needs to know that the U.S. market will remain open to it, even if protectionist pressures mount against imports from other countries. Undeniably, the government's industrial policies are useful in helping restructure Canadian industry, but unless they can achieve reliable access to a larger market—and the United States is obviously that market—they can only be palliative. The long-term future of much of Canadian industry will remain at risk.

It is in this light that the Committee has turned to an alternative approach—the negotiation of a bilateral free trade agreement with the United States. The Committee believes that if Canada is to retain its current standard of living and its present productive capacity into the 1990s, the piecemeal approach to trade liberalization and the reliance on a series of supportive measures must give way to the forthright adoption of this broad policy initiative.

The Committee recognizes that the negotiation of such an arrangement will be an enormously complex undertaking, not without its own risks. But the risks of not moving forward are much greater.

1. Why not multilateral instead of bilateral free trade?

Arguments have been put before the Committee to the effect that free or freer trade on a multilateral basis would be preferable to bilateral free trade with the United States: the economic benefits to the Canadian consumer

would be greater; there would be less danger of being dominated by the United States; the multilateral approach to trade liberalization has been the traditional Canadian route and should continue to be so. The Committee is conscious that there would also be important benefits to Canadian consumers from multilateral free trade. Indeed, the Committee recognizes that multilateral free trade was the Economic Council's first choice in its 1975 report, "Looking Outward", although the Council recognized that practical necessities would require more limited solutions in the short-term. The Committee has noted that, for the past 35 years Canada has supported, with two exceptions, the multilateral non-discriminatory approach as being in its best interest. The two important exceptions are the bilateral arrangements between Canada and the United States related to defence production and automotive products, although even in the latter case Canada accorded MFN treatment to any firm which could meet the qualifications set down for *bona fide* Canadian manufacturers.

Nonetheless, the Committee asks how wise is it for Canada to wait for multilateral trade negotiations (MTN) to achieve better access to the necessary mass markets? How soon are such negotiations likely to be held? To what extent is multilateral free trade achievable by this approach in the foreseeable future?

Aside from certain monitoring and dispute-settlement mechanisms for the GATT non-tariff barrier codes and possibly for some extension of the codes' coverage, the likelihood is that another full-scale multilateral trade negotiation will not take place before the mid-1990s. Indeed, some observers consider the Tokyo Round may be the last such meeting. Even if there were subsequent meetings, there are doubts that they are likely to serve Canada's interests. Reflecting on the Tokyo Round in a recent article, Mr. Rodney Grey said that "the MTN showed how little we can expect from the EEC and Japan in the way of accommodating our particular interests. We got from them, and we will get from them in future negotiations, only what happens to fall out of their negotiations with the U.S.A." In short, the GATT multilateral trade negotiations have now effectively become a 'club of three,' a tripartite negotiation in which the voices of the United States, the European Community and Japan are the only ones that really count. Canada should not blind itself to the realization that it can no longer continue to play a significant role in such negotiations.

Even in the event that there are other MTNs, Professor Ronald Wonnacott of the University of Western Ontario predicted that full trade liberalization will not be achieved, only progressively smaller and smaller steps toward it. This is not what Canadian industry needs, he said.

"... we won't satisfy Canada's important requirement that we achieve essentially free access to foreign markets and, in particular, the U.S. market. That last step

is the crucial one because if you are talking about rationalizing Canadian industry, you are talking about increasing scale enormously. If you have a guarantee of access to that U.S. market, then you can engage in the large scale investment this implies, whereas if there are tariffs remaining—even though they be small—they put such enormous investment at considerable risk (18:17).”*

In fact, a strong case can be made that small, gradual tariff cuts are not only unhelpful to a country like Canada but will actually put it at a considerable disadvantage. Canadian manufactured goods tend to be high cost, for reasons mentioned earlier. Small, graduated reductions in foreign trade barriers do not give Canadian producers enough scope for the needed rationalization and specialization to reduce costs and to become more competitive. On the other hand, similar small cuts in the Canadian barriers will allow the foreign manufacturer—already more cost competitive due to economies of scale possible from his own larger market base—to make sharp inroads into Canada with his imports. It is questionable whether the GATT liberalization approach, in the long run, will provide the incentive for Canadian producers to undertake the reorganization necessary to compete internationally.

In any case the existing pattern of Canada’s exports to Community and Japanese markets suggests there would be relatively little benefit to Canada’s manufacturing sector even if better access were granted. **Japan and the EC take only from 3 to 10 percent of their imports from Canada in manufactured goods as distinct from raw resources, while the United States takes 68 percent of its imports from Canada in manufactured goods as opposed to raw materials.**

Moreover, Canadians have witnessed, in recent years, an evident trend to regionalism in international trading patterns. The European Community, with its common market, has grown from six to nine, then to ten, and possibly soon to twelve members. Add to this the Community’s agreements for free trade in industrial products with the six remaining EFTA countries and North America is confronted by a vast sixteen-country free trade network across Europe. This situation has not been reassuring for Canada or the United States, more particularly because it seems to be accompanied by a gradual chipping away of the MFN principle of non-discrimination.

Other arguments against bilateral free trade have emphasized the benefit of the multilateral system to a smaller country by allowing it to have more leverage against a larger country. Pointing to the power disparities between Canada and the United States, the multilateralist proponents argue that not only have extra benefits accrued to Canada because it is automatically accorded the gains wrung from the United States by other trading entities

* Numbers refer to the Committee Proceedings. The first number indicates the issue number of the Proceedings and the second number indicates the page. Unless otherwise stated, all refer to the First Session of the Thirty-Second Parliament, 1980-81.

like the EC or Japan but also, in a dispute with the United States, it has been helpful for Canada to have, around the negotiating table, stronger countervailing forces with objectives similar to its own.

The Committee recognizes the benefits accorded to Canada from the GATT multilateral system over the past 35 years. But it does not see why continued support of the GATT liberalization process and a Canada-U.S. free trade agreement should be considered mutually exclusive. In a bilateral free trade area with the United States the 'most-favoured-nation' type of gains which have been achieved through the GATT will continue to be accorded to Canada. In fact, in future GATT panels, Canada could be the beneficiary of a stronger North American point of view on many issues. At the same time, Canada should remain realistic about how few new gains it can achieve in this forum and how its specific interests are more likely to be served in a Canada-U.S. arrangement.

As for bilateral disputes with the United States and the disparity-of-size question, it is interesting to note that the free trade agreements between the European Community and Austria, Finland, Iceland, Portugal, Sweden, Norway and Switzerland were negotiated on an individual country basis. In each case, the size disparity with the Community is greater than that existing between Canada and the United States. For each bilateral agreement, a separate joint committee was established and a dispute-settlement procedure was spelled out. Any bilateral Canada-U.S. free trade agreement would of course include such a dispute settlement body.

The establishment in mid-1981 of a trilateral trade consultation body comprising the United States, the European Community and Japan threatened to leave Canada 'out in the cold'. Developments such as this make it all the more important for Canada to seek a strong bilateral negotiating structure with the United States. Otherwise the United States may tend to forget the interests of its major trading partner, Canada, in its preoccupation with Europe and Japan.

Another argument which has been presented against a bilateral arrangement and which is difficult to understand is that Canada would sacrifice its existing third country markets. **But Germany and other European countries have not stopped trading with the rest of the world since they joined the European Community. Quite the contrary, their trade with third countries outside the Community has flourished.**

The Committee has concluded, therefore, that multilateral free trade is not an achievable goal in the next 20 years and that many key Canadian interests are unlikely to be served by future GATT negotiations. Moreover, the Committee asks why Canada should wait for gradual multilateral trade liberalization to attain its assured mass markets when its main competitors

already have theirs? For instance Japan has a free market of over 100 million, the European Community and the former EFTA countries have one of 350 million and the United States one of 250 million. **These are the three markets with which Canada conducts between 80 and 90 percent of its trade.**

A very important argument for taking positive action now, rather than waiting for gradual GATT liberalization, relates to the fact that Canada is actually "backing eyes shut" into closer economic integration with the United States.* The fact is that the Tokyo Round tariff cuts will mean over 95 percent of Canadian exports to the United States and 85 percent of imports from the United States will trade duty free or at duties of less than 5 percent by 1987. Whether Canada is aware of it or not, it is moving inexorably into a more interdependent trading relationship with the United States. In 1980, a joint Canadian-American study** found that each economy has become increasingly dependent on the other for a broad range of goods. Since the present tariff structure discriminates against imports of highly fabricated goods, trade in intermediate products has been encouraged with a resulting integration of production processes. Moreover, the trend by Canadian multinationals to locate within U.S. borders, in order to escape tariff and non-tariff barriers, is leading to increasing cross-border patterns of ownership, product development and design. Professor Sidney Weintraub of the University of Texas made a similar point in testimony to the Committee. Even by taking no steps at all, the two economies are integrating more and more, he said, and he could not think of another pair of independent industrial countries which were already so thoroughly economically interdependent. The point is that Canada, by maintaining bilateral trade barriers is actually unwittingly intensifying the economic integration of the two countries.

At the same time, by not recognizing the increasing trading interdependence, by not taking positive action to formalize it, and by not negotiating benefits, safeguards, adjustment arrangements and, most especially, a preferential access over non-tariff barriers, Canada confers on itself the disadvantages of an unprotected market and foregoes the positive advantages possible under a bilateral free trade arrangement. **By not facing up to the reality of the situation now, Canada will increasingly feel the costs without any of the benefits of free trade.**

Bilateral free trade offers two other important advantages over multilateral free trade. First, Canadian industry would feel less competition from third country imports because it could retain its tariffs against these competi-

* As pointed out by the *Financial Post*, 17 March 1979. "Psst-we're backing, eyes shut, into closer trade ties with the U.S."

** Peter Morici, *Canada-United States Trade and Economic Interdependence*, C.D. Howe Research Institute (Canada) and National Planning Association (U.S.A.) 1980

tors. Secondly, Canada would receive preferential treatment in the U.S. markets vis-à-vis third country imports because the United States could also retain its tariffs and/or quotas against these countries. Moreover, a multilateral free trade agreement would be much harder to negotiate than a bilateral agreement. With only one partner, Professor Ronald Wonnacott pointed out, a better set of transitional safeguards can be negotiated and the sequencing of tariff cuts and the diminution of non-tariff measures can be phased in at a rate more cognizant of Canadian requirements. The monitoring of such reductions can be effectively carried out with one partner but could well prove almost impossible with a host of far-flung trading countries.

2. Not a common market nor a customs union

It needs to be clearly understood what the Committee is recommending. **It is a free trade arrangement between Canada and the United States. It is not a common market nor a customs union.**

It has been evident from the Committee hearings, from press comments and even from academic writing that too many Canadians in government, in the media and in business fail to distinguish the important differences between a free trade area and a common market or customs union.

To begin with, a free trade area would provide for the elimination, by stages, of certain remaining tariffs. Secondly, and more importantly, a bilateral free trade arrangement would provide Canada and the United States with a mechanism for negotiating the elimination or reduction of non-tariff barriers between the two countries. A bilateral free trade agreement would have no bearing on the external tariff or non-tariff barriers which either country might wish to employ against the outside world.

The proposal for a Canada-U.S. free trade agreement is aimed at strengthening Canadian industry by helping it to rationalize in sectors where it has been losing its traditional high tariff protection without gaining the advantages of its competitors, namely the assurance of a larger market.

The Committee would like to underline what its proposal for a Canada-U.S. free trade arrangement is NOT:

- It is not a North American common market
- It is not a Canada-U.S. common market
- It is not a proposal for a pooling of energy resources
- It is not a proposal for political integration
- It is not a proposal for 'continentalism', if that word is used in the pejorative sense rather than in the context of mutual cooperation

A common market or customs union—as distinct from a free trade area—involves free movement of goods, labour and capital between member

states which agree to be bound by a common external tariff against the rest of the world and which agree to the harmonization of non-tariff barriers and a host of other matters as between themselves and in their relations with the outside world. In addition, the best known example of a common market, the European Community, specifically contemplates a degree of political cooperation (as evidenced by the recent direct elections to the European Community parliament) even if not full political union. The hesitancy of some nations to join the European Community, as was the case with Great Britain, is related to the fact that in so doing they would indeed be gradually relinquishing a considerable degree of national sovereignty. **None of the free trade agreements entered into between Finland, Sweden, Norway, Austria, Switzerland and Portugal with the European Community have these characteristics. Nor would such an agreement between Canada and the United States.**

A free trade agreement would have no bearing on Canadian mineral or other resources which Canada could export or not as it chose. Such resources are generally not subject to tariffs in any case, except when they are upgraded. Free trade would encourage and enhance the possibility of such upgrading by giving the upgraded resources free access to the U.S. market. Oil, natural gas and electricity are not dutiable and would continue to be subject to exactly the same regulatory authorities and permits in both countries as they are today. If Canada and the U.S. followed the European examples, agriculture and even fisheries would not be included in such an agreement even as far as tariffs are concerned (and such an exclusion is permitted under the GATT). Canadian quotas on textiles and shoes against third countries would not be affected. On the contrary, the Canadian textile and shoe industries could continue to have the same protection as they have now vis-à-vis the rest of the world and yet have free access to the U.S. market.

Bilateral free trade would not mean free movement of labour between the two countries. As far as movement of capital between Canada and the United States is concerned, there is already such a degree of free capital movements that this is not likely to be a significant issue. However, even within the European Community, there have been certain restrictions on the movement of capital. Policies which could be seen to influence the movement of direct investment flows such as Canada's FIRA would undoubtedly require examination during negotiations, and Canada would likely press for retention of the FIRA screening process during the transition period. (See page 85).

Free trade does not mean political integration between the two countries.* It is worth recalling again the examples in Europe of a free trade

* The important question of the political implications of bilateral free trade is dealt with more fully in Part VI.

arrangement—the EFTA—and of a common market—the European Community. When the six-member European Community was first formed, the other European countries, namely the United Kingdom, Sweden, Norway, Denmark, Iceland, Portugal and Switzerland and subsequently Austria and Finland formed in 1957 a free trade area (EFTA) which involved free trade in industrial goods but none of the other characteristics of a common market or customs union. When the United Kingdom and some of the other members of EFTA later joined the European Community in 1972, EFTA was effectively terminated whereupon all of the remaining smaller countries of Western Europe, including Switzerland (6 million population), Portugal (9 million), Sweden (7 million), Austria (7 million), Finland (4.5 million) and Norway (3.7 million) all decided to negotiate industrial free trade agreements with the European Community (225 million). In each case, individual free trade agreements with the EC were signed. In every instance this involved a disproportion of population substantially greater than Canada's population relationship to the United States.

As the Committee pointed out in its earlier report, Finland's case was particularly interesting. During its association with EFTA, Finland had monitored its exports of industrial goods and found that they were expanding more rapidly with the rather sluggish United Kingdom economy within EFTA's free trade arrangement, than with Germany whose economy was booming. Germany had traditionally been Finland's closest trading partner, but Finland did not have free access to its market. It was this experience that persuaded Finland to enter into the free trade agreement with the Community.

The experience of the Republic of Ireland (Eire) which has had free trade with Great Britain for many years is equally persuasive. In 1966, a free trade area, patterned after the EFTA agreement, was established between the United Kingdom and Ireland. The United Kingdom ended all protective duties on imports from Ireland immediately and the Irish Republic undertook to eliminate protective duties on most U.K. imports in 10 equal instalments over a period of nine years. A large proportion of trade in both directions had been already trading freely. The Irish government emphasized that the agreement was "a trade agreement and nothing more" with no political implications. Minimal institutional links were set up and little or no policy harmonization resulted, although a degree of policy harmonization already existed. While this agreement did not run its full course, as both countries entered the European Community in 1972, a significant increase took place in Anglo-Irish trade and the volume of Irish industrial exports to all countries expanded in the 1965-70 period.

The case of the Australia and New Zealand free trade area is also instructive. Prior to the arrangement, New Zealand had a very large trade

deficit with Australia; each country was its own best market for manufactured products but New Zealand was concerned by the greater strength and sophistication of the Australian industry. In 1966 a bilateral trade agreement created a limited free trade area for 13 million people. The agreement covered only about 50 percent of the actual trade, much of which was already trading freely and it included numerous resource products. In the first seven years of the agreement, trade between the two countries increased by 78 percent and the balance of trade in favour of Australia declined from over 4 to 1 to 2 to 1. Formal institutional arrangements were slight. The agreement appears to have been advantageous for the smaller partner.

All three examples resulted in expanded trade for the smaller partners. None of the foregoing free trade arrangements resulted in any discernible political integration. (See Part VI).

B. A Bilateral Agreement and the GATT

Having reached the conclusion that the appropriate policy for the government of Canada is to seek a bilateral free trade agreement with the United States, the Committee addressed the important question of how this should be done. Given both countries' long-standing commitment to the ideal of non-discrimination in international trade relations, it seems very desirable that a free trade arrangement should keep within the legality of the Articles of the GATT. Any other course would be likely to invite retaliation from third countries, an outcome which the United States, as well as Canada, would seek to avoid. Moreover, it is unlikely that either country would wish to see an 'unravelling' of all the solid achievements of GATT in liberalizing trade, an undoubted risk if the major trading nation, the United States, were a party to an arrangement which openly flouted the GATT Contract.

The Committee explored various policy options permissible under GATT rules in the concluding of a bilateral trade arrangement. The basic principle of the GATT treaty governing a trade agreement is one of non-discrimination, that is, each of the signatory countries must extend to all others, on a non-discriminatory basis, any concessions it may negotiate on both tariff and non-tariff barriers to trade. Article XXIV of the GATT treaty, however, permits signatories to negotiate customs unions and preferential free trade agreements as long as certain conditions are met. Alternatively in cases where these conditions are not met, limited preferential arrangements may be granted if approved by a two-thirds vote of the GATT signatories under a waiver procedure set out in Article XXV. The United States, but not Canada, obtained such a waiver for its bilateral preferential Auto Agreement in 1965.

1. A pragmatic approach

Rather than a broad free trade agreement, Mr. Rodney Grey suggested a pragmatic approach. In areas where GATT had left "unfinished business", such as procurement, petrochemicals, countervail, etc. Mr. Grey proposed that Canada and the United States should try to conclude separate issue-by-issue bilateral arrangements for freer trade. The resulting benefits of better access would be offered simultaneously to those countries which were prepared themselves to offer better access, a process known as a conditional most-favoured-nation (MFN) approach. In the case of petrochemicals, however, he told the Committee it might even be necessary to conclude a preferential bilateral agreement, "abandoning the strict rule of non-discrimination." In this fashion, said Mr. Grey "we might evolve piece-by-piece, policy area-by-policy area, a special trading regime or arrangement."

The Hon. Larry Grossman, Minister of Industry and Tourism of the Government of Ontario advocated the same approach. Making clear his opposition to general free trade with the United States and acknowledging that Mr. Grey was an adviser to the provincial government, he explained that what Ontario wanted was "in certain sectors, when it would benefit our economy, structured, carefully negotiated bilateral free access to the American market."

Initially this approach seemed attractive for two reasons: first, the objectives were simple and limited and appeared accordingly to be more likely of speedy resolution; and secondly, negotiations might be limited to selected areas where, as Mr. Grossman suggested, the benefits to the Canadian economy would be undisputed. This would have avoided the need, painful to the politician and difficult for the negotiator, of taking risks and making concessions.

It is the Committee's understanding, however, that this approach would require a series of waivers under Article XXV or risk retaliation. GATT experience shows that third countries, even if offered a conditional MFN situation whereby they could opt into a sectoral agreement if they reciprocated with equal access into their own markets, might challenge a bilateral agreement not concluded according to the Article XXIV provisions. They would be almost certain to do so if a preferential bilateral sectoral arrangement were concluded outside the GATT context. In the case of petrochemicals in particular, major petrochemical-producing countries in the European Community would likely be particularly resistant.

Quite apart from these theoretical difficulties, the Committee has failed to detect any American interest in this pragmatic approach. An inquiry by the U.S. Chemical Manufacturers Association of its members' attitudes toward a bilateral agreement in petrochemicals showed almost complete dis-

interest; the Committee was told there was less than a 10 percent response, and this in spite of the declared interest of at least one large multinational. The Canadian government has already twice initiated *ad hoc* bilateral negotiations on procurement in the urban transit industry—in 1977 and 1980—with a distinct lack of success. Although the U.S. Administration undertook in July 1979 to consider carefully Canada's request for a waiver from the Buy American provisions of the Surface Transportation Assistance Act, there has been no further response. **If, under the *ad hoc* procedure, this one problem area has proved so difficult to negotiate with so little result, the Committee asks how long would it take Canada to achieve a resolution to the whole range of bilateral issues by such an approach?**

All of the witnesses whom the Committee met in Washington advised against the pragmatic approach. Although the Canadian interest in each special arrangement was very clear, the Americans questioned where the reciprocal benefit lay for the United States; even if a mutual interest could be identified, they warned that Canada's limited bargaining position would be frittered away; they pointed to resistance in Congress to special deals with Canada based on dissatisfaction with the safeguard clauses of the Automotive Agreement. They urged avoidance of the quagmire of sectoral bargaining, which every special interest would try to exploit and which the Congressional system encouraged. **If Canada wanted a special arrangement with the United States, the unanimous advice of the American witnesses was to go the route of a broad free trade agreement. Such an approach, they said, had the potential of attracting genuine support in the Administration and in Congress.**

2. Declaration of a free trade area under Article XXIV

In authoritative testimony prepared at the Committee's request, Professor John Quinn, a legal specialist from the University of Western Ontario, indicated that in establishing a free trade agreement, two possibilities present themselves within the scope of Article XXIV of the GATT: either a declaratory approach or the conclusion of an interim agreement. Article XXIV requires that all restrictions or barriers to trade be eliminated on "substantially all" the trade of goods between the countries concluding a preferential agreement. Past experience of Article XXIV has indicated that the freeing of trade in 80 per cent of traded commodities between the two countries will be deemed sufficient to satisfy the "substantially all trade" threshold. In respect to the declaratory procedure, Canada and the United States might issue a bilateral declaration that a free trade area as defined in Article XXIV should be now deemed to exist between the two countries. From there, the two countries could proceed to liberalize trade further for particular products or sectors.

The Committee has found that, on the basis of the actual bilateral trade statistics and their projection to 1987 when the agreed-to GATT tariff cuts will be in place, Canada-U.S. trade could satisfy or be very close to satisfying the "substantially all trade" requirement laid down by the GATT for the establishment of a free trade area. With the large amount of resource-based products trading freely as well as the large free flow of products under the Automotive Agreement, almost 70 per cent of bilateral trade is at present free of tariffs. As noted earlier, by 1987, 80 percent of Canada's industrial exports to the United States will actually enter duty-free and a further 15 percent will face tariffs of 5 percent or less. On the other side, 65 percent of Canadian imports from the United States will be free of duty and a further 26 percent will move across tariffs of less than 5 percent. Furthermore, the GATT has previously acquiesced in free trade arrangements with less than this threshold of goods trading freely.*

The Committee has concluded that by 1987 a *de facto* free trade area between Canada and the United States could be deemed to exist in respect to tariffs. Under GATT rules, therefore, Canada and the United States could theoretically declare in 1987 that a bilateral free trade area already existed and then proceed on a product by product or sectoral basis to liberalize trade without recourse to further GATT exemptions.

Such a finding might lead the casual observer to ask, if a *de facto* free trade area will exist in any case by 1987, why does Canada need to pursue the matter further. The answer is that the 80 percent of bilateral trade which will be duty-free by 1987 will be composed mainly of resources and resource-based goods plus the substantial duty-free trade under the auto pact, the defence production sharing arrangement and the civil aircraft agreement. Where Canada's problem lies is in the remaining protected 15 or 20 percent, all involving its manufacturing sector which must be rationalized and placed in a world competitive mode if Canada is to redress its \$20 billion trade deficit in end products.

However, there is, in any case, a serious deficiency in the declaratory approach. The main drawback is that it ignores the degree of protection accorded by non-tariff measures. As the Committee has already pointed out, these are becoming more important obstacles to trade than tariffs. They have been recognized as such at the last multilateral trade negotiations. The degree of non-tariff protection is particularly difficult to measure in respect to countervail, customs valuation and anti-dumping procedures. Accordingly, other GATT countries could argue that a bilateral arrangement arrived at

*Agricultural trade would be excluded in a Canada-U.S. arrangement as it has been excluded from consideration in most other free trade arrangements including EFTA. Although this might be cause for complaints by GATT partners, it is doubtful a serious challenge could be mounted on this ground.

through the declaratory approach, which failed to take account of non-tariff barriers, would not fully meet GATT criteria in the present multilateral trade context. The result could be complaints and retaliatory measures against Canada and the United States. Moreover, while the GATT has acquiesced in the declaratory approach for certain other countries which had a lower existing level of duty-free trade, it is extremely doubtful that it would do so when a free trade declaration involved a major world trading entity like the United States. As Professor Weintraub told the Committee, the 'declaration' mechanism could be adversely perceived by other GATT members as being "a bit too cute." The United States would not wish to give the impression it was weakening the GATT. And from Canada's point of view the use of the declaratory approach would give no assurance of resolving Canada's main problem with the United States, that is, non-tariff barriers.

3. An interim agreement under Article XXIV

The second possibility within the GATT Article XXIV framework, Professor Quinn pointed out, would be for Canada and the United States to conclude an "interim agreement leading to the formation of . . . a free trade area". If this route were chosen, a plan and schedule for the achievement of such a free trade area within a reasonable length of time must be provided to the GATT signatories, as well as sufficient information to allow them to make recommendations. This 'interim agreement' procedure is the one which has been used for all regional arrangements placed so far before the GATT. In no case have other GATT signatories made formal recommendations. However, informal consultations may have led to modifications of proposed arrangements. Nor has "within a reasonable length of time" been defined. It would appear from precedent that under this option the two countries would be free to set a timetable of their own as well as a fairly loosely-worded schedule as to when and how the successive stages of further liberalization would take place.* Indeed, what would be involved would be little more tariff adjustment than will be in effect in any case by 1987 but with the essential additional advantage for Canada of a mechanism for negotiating the mutual reduction of non-tariff barriers.

After consideration of the three approaches, two with the objective of a bilateral free trade agreement as provided for under Article XXIV and the third a pragmatic sector-by-sector, issue-by-issue negotiating procedure, aiming only at freer trade, the **Committee recommends as the best approach that Canada and the United States choose the 'interim agreement' mechanism to achieve a bilateral free trade arrangement.** This umbrella-type approach is superior to the declaratory approach, in that non-tariff barriers would be

* There may be a possibility that under an interim agreement, liberalization could be scheduled on a sectoral basis rather than an across-the-board reduction of tariffs over a certain time period. (See page 35).

taken into account and would be included in the plan and schedule. It is also superior to the pragmatic approach which, while attractive to Canada, is open to objections by GATT members and offers insufficient benefits to the United States to be attainable.

The main advantage of the 'interim agreement' procedure is the opportunity it offers, before initial negotiations have been completed, to ascertain the degree of commitment on the part of the United States to reduce, on a bilateral basis, some of its non-tariff barriers which are causing problems for Canada. At the same time, the preliminary negotiations would reveal the objectives of the United States with regard to Canadian non-tariff barriers. In effect, under this approach each side could test the other's position before ratifying a treaty or otherwise committing itself to an agreement. In the area of non-tariff measures involving unknown elements, such a procedure would offer an important advantage.

4. Across-the-board or one issue and one sector at a time?

Under the umbrella of an 'interim agreement' to move to a bilateral free trade agreement with the United States, it might appear on the surface more advantageous from a Canadian perspective to proceed slowly to free trade, that is freeing one sector, (eg., the petrochemical sector) or one issue, (eg., procurement) at a time. Seemingly the cautious approach might permit Canada to focus on the areas of major impediments to its exports and to adjust gradually to the dislocations which would occur. It would reduce political opposition in Canada and avoid economic risk. The Committee has heard advocates of such a course and the petrochemical industry was advanced as an area where one might begin. However, there are no successful precedents for free trade areas which proceeded sector-by-sector under the GATT. Moreover, even if it were established that the two countries could, under the umbrella of an interim agreement, negotiate one issue or sector at a time to further liberalize trade, rather than present a broad plan of liberalizing trade across the board, the Committee was warned by a number of witnesses, including knowledgeable Americans, that such an approach would be inadvisable and unworkable. To begin with, the complications in negotiating a balance of costs and advantages for each country in each sector would be so great as to thwart the reaching of an agreement at all. Professor Weintraub of the University of Texas stated:

"It is much harder to reach any kind of free trade arrangement if you do it sector-by-sector. The issue is thereby complicated rather than simplified. . . We started out in GATT by negotiating item-by-item, which became so cumbersome that we had to shift to across the board negotiations, with exceptions. The European Community. . . reduced duties across-the-board, rather than negotiate item-by-item. The Latin American Free Trade Association chose a different path. It chose item-by-item negotiations and failed, and the organization no longer exists."(17:11)

The second reason to avoid the sectoral approach, he told the Committee, was that in any one sector, one country or the other would have the advantage. It would be difficult to find other industries like the automotive industry where there are mutual advantages for the two countries and even the auto pact arrangement has been the subject of constant bilateral arguments. Within single industrial sectors it would be almost impossible to ensure that, under free trade, the two countries would gain equal benefit from employment, investment or production no matter what temporary safeguards were obtained. Moreover, quid pro quos would be difficult to find. Even the petrochemical industry which had initially advocated a sectoral free trade agreement in petrochemicals has acknowledged the difficulty of negotiating an acceptable trade-off within the industry which would be attractive to U.S. producers. In testimony, Mr. Jack Dewar, president of Union Carbide Canada, told the Committee

"No matter how hard I try, I cannot think of another situation in the area of petrochemicals and their feedstocks which would be considered equitable to the U.S. yet advantageous to Canada. . . I do not want to leave the impression that the quid pro quo must be within the petrochemical industry or allied to it." (9:12).

A free trade arrangement made in one sector would have an impact on another sector not covered. It could be exceedingly difficult to separate out inputs and components used in both sectors. Finally, there would be a problem deciding which industries should benefit, and in what order, from sectoral bilateral free trade arrangements.

The Committee concludes, therefore, that under an interim agreement, the only approach likely to succeed would be one which addressed the whole spectrum of trade and set out the planned reductions staged over a transition period. However, as various witnesses have pointed out, this broad approach does not mean that longer transition periods could not be negotiated for particularly sensitive items. Nor need everything be included. **The most feasible approach, suggested by several witnesses, would be to include everything except those items which were specifically excluded, rather than excluding everything unless specifically negotiated.** As noted earlier, agriculture would not be included in the agreement. This exception accorded with the views of American witnesses and is consistent with the example of EFTA.

5. A preferential or an 'open-ended' agreement?

Having thus determined that the most appropriate mechanism for bilateral free trade would be the 'interim agreement' method, setting forth a plan or schedule for an across-the-board freeing of trade, the Committee looked into whether the bilateral free trade agreement should be on a preferential basis, as would be the normal procedure under the protection of Article XXIV, or whether it should be open on a conditional MFN basis to those countries which would care to opt in on a reciprocal basis.

A number of witnesses have urged that a Canada-U.S. free trade agreement should be 'open-ended' to multilateral extension, possibly on the basis of the conditional MFN type of clause adopted in the Trade in Civil Aircraft Agreement at the Tokyo Round. Under this agreement, free access is mutually accorded between the signatories, but the full benefits may be further extended to any other GATT member which wishes to open its markets for these products on a reciprocal basis.

In view of the February 1981 trade policy statement by the U.S. Special Trade Representative which emphasized the Reagan Administration's adherence to an "open and fair" trading system within the GATT framework, and its desire to explore possible new areas for "additional liberalization", the Administration, initially at least, may be predisposed to the option of an open-ended arrangement.

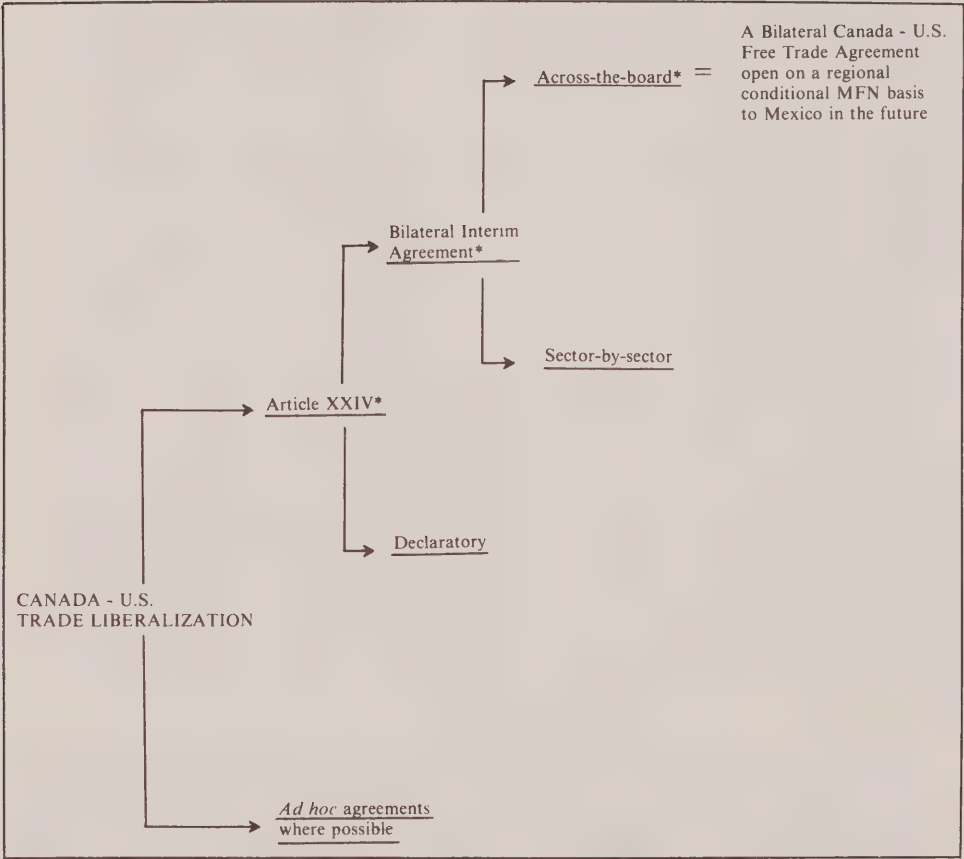
It is also recognized that the United States will undoubtedly wish to keep open the possibility of moving toward closer economic co-operation with its southern neighbour, Mexico. Various proposals for a North American trilateral arrangement between Canada, Mexico and the United States have been made. But Mexico is still at an entirely different stage of development than Canada and the United States. These differences are recognized by the U.S. Administration. In transmitting the report on North American Trade Agreements to Congress in August 1981, President Reagan stated that "improving trade relations with Mexico and Canada separately rather than on a regional basis seems appropriate at the present time". Mexico's industry is highly protected and the country is not yet a member of the GATT. Mexican wage rates are considerably lower than either country's and, consequently, the special concerns of U.S. labour vis-à-vis Mexican labour would be quite different than their concerns vis-à-vis Canada. There is in Mexico a comparative lack of industrial infrastructure and of industries that could supply inputs for further manufacturing. The market for many advanced consumer goods is limited. Noting these differences, Professor Weintraub has suggested that with Mexico's current state of development, it would be impossible at present to think of a balanced trilateral free trade arrangement. From the U.S. point of view, two concurrent sets of bilateral arrangements, i.e., a Canada-United States and Mexico-United States arrangement, would be more appropriate than a three-way agreement, he concluded.

The Committee agrees that the time is not yet ripe to forge a truly North American free trade area including Mexico. Instead, the Canada-United States bilateral free trade agreement should be drawn up but specifically couched in regional North American terms. It could include a conditional MFN proviso to the effect that whenever Mexico was ready to offer comparable access conditions it could become part of the North American Free Trade Area. While other GATT signatories such as member countries of the

European Community may not like the arrangement, there would be little cause for them to take retaliatory actions since they themselves are members of regional groupings, both the European Common Market and the free trade arrangements with former EFTA countries.

In summary, the 'decision tree' that follows attempts to present graphically the Committee's arguments for the best approach, the asterisks indicating the preferred route to follow.

The 'Best Approach' under GATT to a Canada-U.S. Trade Agreement



* The asterisks indicate the Committee's preferred approach.

C. U.S. Reaction to a Bilateral Free Trade Proposal

Reasons for U.S. interest

What interest would an economic giant of 230 million people, with an annual merchandise trade volume amounting to \$470 billion and a GNP of \$3,000 billion have in entering into a free trade agreement with a country of 24 million, an annual trade of \$148 billion and a GNP of \$290 billion? During its hearing the Committee asked this question of many witnesses including a number of knowledgeable Americans. Some interesting points emerged.

First, the concept of closer regional relations has been advocated in recent years by prominent U.S. political figures. In particular, President Reagan (then Governor), in the official announcement of his candidacy for president in November, 1979 urged "a developing closeness among Canada, Mexico and the United States—a North American accord." In addition, as mentioned earlier, the U.S. Administration was instructed by Congress in the 1979 U.S. Trade Agreements Act to study the desirability of entering into trade agreements with Canada and Mexico. (Such a study is a rare occurrence since the Executive is seldom mandated by Congress to produce a sensitive policy-oriented report. Officials admitted to the Committee in Washington that the fact that the report would be a public document limited the scope of the recommendations.)

In August, 1981 President Reagan transmitted the results of the Administration study to Congress. "The American people and our North American neighbours will benefit from reciprocal trade liberalization" wrote the President in his covering letter. The report itself spoke of "the clear economic arguments which can be made in favour of greater regional integration." It stated that U.S. industries might have "fewer reservations about trade liberalization with Canada due to a more comparable level of economic development" than with Mexico which could be seen as threatening jobs and markets with cheaper goods. One could assume, therefore, that given the Reagan Administration's known advocacy of freer trade, the President's original proposal in 1979 for a North American 'accord,' as well as the Administration report, any proposal for bilateral free trade by Canada would likely be given a fair hearing in Washington.

There is an important argument for bilateral free trade which the Committee considers would be persuasive to Washington and should be equally persuasive to Ottawa. Mr. Lawrence Krause of the Brookings Institute, suggested that the appropriate approach to Washington for Canada would be to present a projection of what would be likely to happen if the two countries maintain the status quo, without taking positive action to move to free trade. In today's very close interdependent relationship, more and more domestic

policies impinge negatively and often inadvertently on the neighbouring country. Increasing confrontations in trade are likely to arise. To forestall this growing irritation, Mr. Krause suggested the following Canadian approach to Washington.

"... The argument is that you should not believe that the status quo can be maintained; it will get worse; our difficulties bilaterally will get worse. So let us think of a scenario which says: Rather than reacting to these negatives that are clearly down the road, let us head them off by taking a positive road. That is the way we are going to offset the negatives. That will be the strongest argument, because it is always the inertia of liking the status quo that is hardest to overcome." (7:12)

This argument raises the telling point of the increasing inevitability of bilateral clashes, a point which has become evident to the Committee as it reviewed the two countries' industrial policies. It also reflects a recognition, spelled out in the President's letter to Congress transmitting the Trade Representative's report, that some recent efforts by Canada and Mexico to reduce their dependence on U.S. trade "have conflicted with principles of liberal trade and with U.S. trade laws". Moreover, Mr. Rodney Grey observed that trade disputes between the two countries will tend to erupt more easily without the stabilizing factor of ongoing multilateral trade negotiations to provide a forum for dialogue.

"The fact that we were negotiating, that there was ongoing discussion, that there was a working apparatus to deal in a context of problem-solving with the new problems as they arose, was a major element in the management of trade relations for most of the 1970's. Looking ahead, one factor to take into account is that there is no general negotiation taking place, and that influence on events is no longer there..." (4:6)

On the basis of such concerns, a convincing case can be made to American authorities that the 'status quo' will get worse and that positive action is needed to promote effective and harmonious bilateral trade relations and to avert an unwholesome drift into discord.

Another consideration, not irrelevant to the likely U.S. reaction is its own international economic position. The United States has been in the forefront of the international trade liberalization process for the past three decades. But the 1970s witnessed a decline in its leadership relative to a strengthening position of the European Community and Japan. The United States is itself becoming concerned by its current position in world trade. In his testimony before the Joint Economic Committee of Congress early in 1981, the Special Trade Representative, Mr. William Brock underlined the decline of the former "economic superpower." From 1960, when the United States accounted for 45 percent of the market economies' output, its share has fallen to 29 percent by 1980. Its share of world exports has declined. Its productivity has declined, both "in absolute terms and relative to other major industrialized countries." Since 1976, productivity growth in the business sector has remained flat, while hourly wages increased by 28 percent—an unfavourable

performance when compared to that of Japan, Germany or France, he said. There has been a rapid internationalization of the U.S. economy, with total trade as a share of GNP rising from 7.43 percent in 1950 to 12.3 in 1970, and 16.4 percent in the first half of 1980.

Moreover, despite the present Administration's stated commitment to preserving or strengthening an open multilateral trading system, there are signs that the U.S. psyche may be becoming bruised. Persistent U.S. attempts to persuade the Community to diminish its agricultural protectionism, or to persuade Japan to reduce its barriers to access in its internal market, have not met with any significant success. There are some indications that the United States may turn increasingly to protect itself by applying vigorously the legal and regulatory mechanisms which it now has legal recourse to. If the United States were to put up a protective dike vis-à-vis the major trading entities, it might be inclined to welcome a strengthened regional, i.e. North American, base.

While the size of the Canadian market could not be seen as a major drawing card to the U.S. negotiators for improving international trading competitiveness, it could not be considered negligible. There would be substantial economic gains for certain regions and certain sectors in the United States from a bilateral free trade area. U.S. manufacturers, including U.S. firms operating in Canada, could benefit from a larger market and improved efficiency. The President's letter to Congress emphasized this point, stating that further rationalization of companies across the border "might permit greater economies of scale and enhance North American industries' ability to meet competition from the rest of the world".

Mr. Grey summed up the U.S. economic interest in further trade liberalization with Canada when he was asked why the United States might welcome initiatives from Canada:

"The motive for the United States being willing to negotiate away some of the problems is the motive to which we have often appealed in the United States; that is their interest in Canada having a strong economy. . . they understand that they are not going to better themselves by weakening us since we are their principal customer. Senior American policymakers do adjust their policy in the light of that requirement." (4:14)

Indeed, the Committee has heard U.S. officials emphasize the U.S. concern that their major trading partner, Canada, should have a strong economy. Moreover, although it has been established that a smaller country gains most economically in a free trade arrangement with a larger country, studies have shown that there are also economic benefits for the larger country, in this case, the United States.

Some observers are of the opinion that the long U.S. devotion to the GATT would work in favour of a multilateral approach to further trade lib-

eralization rather than a bilateral or regional approach. For 35 years, they argue, the United States has played a leading role in the development of non-discriminatory trade policies and it would therefore be unwilling to arouse opposition from important trading partners which could lead to the undermining of GATT or the 'unravelling' of the liberalizing gains it had achieved. Further, the present U.S. Administration in a February 1981 speech by Mr. William Brock, the U.S. Trade Representative, has voiced its intention to "preserve and strengthen the open and fair system" constructed by GATT.

Responding to such arguments, Mr. Julius Katz, a Committee witness and until recently a senior State Department official, agreed that initially there might be a negative reaction by GATT third countries to a Canada-U.S. agreement. But he did not consider this was a sufficient reason not to proceed. While the gains of GATT had been impressive over the years, he said, unfortunately, in recent years, one form of protection has been frequently replaced by a new impediment. Therefore, "some in Canada and some in the United States seek a new approach to trade liberalization". Nor did he think a bilateral free trade arrangement would be contrary to the interests of the rest of the world. He was convinced that the trade creation effects of such an arrangement would overcome the trade distortion effects, and that the effects on the North American economy would, in the long term, benefit the larger world community. Even if Mexico came in, the trade creation effects would swamp the trade distortion effects, he added.

In arguing for a bilateral approach, a U.S. witness cautioned that it would be important for the United States not to give the impression that it wished to weaken the GATT and for this reason it would want to use the interim agreement formula sanctioned by GATT. Indeed, the Trade Representative's report explicitly discussed the requirements an agreement must fulfill in order to fall within the legality of GATT Article XXIV. Even if Japan or the Europeans expressed concern in the GATT about discrimination, Professor Weintraub said their complaints would "ring hollow given their own discrimination". In this case, the response of the United States should be that the trade diversion would be insignificant since the two economies already are substantially integrated and formalizing this fact would be unlikely to cause damage.

As long as the procedure followed was generally permissible under the Articles of the GATT, the Committee considers that the traditional commitment of the United States to a multilateral trade liberalization process should not constitute a barrier for the United States to enter a bilateral arrangement.

Nonetheless, in view of the Reagan Administration's policy to seek further multilateral trade liberalization and to work for an "open and fair" trading system, it may not wish to enter a preferential trade arrangement with

Canada alone. The Committee is convinced for reasons set out on page 37, that the United States will be more likely to accept a bilateral agreement with Canada if it is set in regional terms with provision for eventual participation by Mexico if that country should in the future wish to do so. At present, however, there would be problems with a trilateral trade liberalization arrangement. As the U.S. Trade Representative's report pointed out, while tariff barriers between the United States and Canada are moderate to low and will become even more so as the two countries continue to phase in the MTN, tariff barriers in Mexico remain relatively high. Nor would Mexico find such an arrangement very attractive, the report continued, partly because of the low rates of U.S. duty, and partly because it is extremely sensitive to competition in products where it has high barriers.

Would the United States be likely to prefer a sectoral approach or an across-the-board approach to trade liberalization? American witnesses considered it was unlikely that a series of sectoral approaches to bilateral trade liberalization would be easy for the Administration to defend politically. It would seem to smack too much of a series of special deals with Canada. There has been intermittent criticism of the auto pact in the United States, leading to the conclusion in some quarters that it has been more trouble than it is worth. While it is true that the 1981 Trade Representative's report said that the most promising sectoral arrangements would be with Canada rather than Mexico because of the extensive network of business arrangements, at the same time it pointed out the political difficulty in finding a balance of advantages in a series of sectoral agreements with Canada. "The industry being sacrificed by one country in return for benefits obtained elsewhere would try to block the agreement," stated the report. It also foresaw difficulties in a sectoral approach with respect to production safeguards and GATT waivers. Summing up the various private sector opinions on North American trade liberalization, the report concluded "these rather broad-based concerns point to the necessarily comprehensive nature of a possible North American Trade Agreement."

The United States would undoubtedly be reluctant to enter into a free trade agreement with Canada to which the provincial governments were not bound. Yet while the U.S. Constitution enables the federal government to enforce trade rules on state and municipal jurisdictions, the Canadian federal government is limited to a co-ordinating or exhorting role in respect to provincial non-tariff barriers. This has been the case not only in respect to Canada's international commitments under GATT but between one province and another. Before a Canada-U.S. free trade arrangement could be negotiated, the Canadian federal government would need to have obtained some sort of negotiating mandate from the provinces in respect to non-tariff barriers affecting access of U.S. products.

Of course, only if Canada showed itself seriously committed to the idea of bilateral free trade, would Washington want to look seriously at such a proposal. This point, raised by an American witness, Mr. Krause, probably reflects American unwillingness to repeat the experience of 1947-48, when officials of the two countries, with Cabinet approval, had worked strenuously on a plan for bilateral free trade, only to have the rug pulled out from under them by a sudden reversal of the Canadian Prime Minister's approval. It should be noted that, historically, the United States has supported the idea of free trade with its neighbour to the north.

Coverage of the agreement

As stated earlier, testimony from American witnesses, including those heard in Washington, persuaded the Committee that the United States would be far more receptive to a broad across-the-board agreement, rather than a sectoral approach, in view of the difficulties in finding *quid pro quos* and the difficulties of negotiation. Within this broad agreement the United States would, like Canada, undoubtedly wish to exclude some items, protect certain others, or phase them in gradually—all possible procedures under GATT rules. Most U.S. witnesses agreed that agriculture should be excluded, a precedent already established by EFTA, although Professor Krause thought that even U.S. farmers would support closer economic integration with Canada if it resulted in a co-ordinated marketing strategy for agricultural products in world markets.

It was generally agreed that each side could continue its own energy regulations, including controls on exports, but one U.S. witness foresaw difficulties if Canada wished to continue a two-price system, selling energy in its domestic market at a subsidized price and to the United States at a high world price. A subsidized price would constitute a non-tariff barrier to a partner country and would probably be inconsistent with a free trade area.

One other area of coverage in a free trade area was mentioned by numerous U.S. witnesses as being an important inclusion from Washington's viewpoint—that is, trade in services. It has been scarcely considered in Canada. The U.S. Administration has recently put considerable emphasis on trade in services (such as banking, insurance, transportation and communications) which it considers is among the most dynamic sectors of the economy and potentially one of the major sources of increased productivity in the coming decade. Mr. Brock has stated that exports of services now amount to one-third of total U.S. exports of goods and services and the U.S. Administration is currently pushing in the OECD and the GATT to formulate rules and procedures for liberalizing trade in services, similar to those developed for trade in goods. In Washington, American witnesses told the Committee that bilateral arrangements in trade in services could be entered into without con-

travening any GATT principles. According to several American witnesses, the United States might also consider it important to include investment flows in a bilateral arrangement. During the discussions the Committee held in Washington, there was specific mention of FIRA and the NEP with respect to the freedom of investment flows.

The U.S. legislative schedule

A bilateral free trade arrangement with Canada would inevitably require a vote of approval by two-thirds of the U.S. Senate. It would have to undergo close critical examination by both Houses of Congress. Professor Fred Bergsten, formerly Assistant Secretary of the U.S. Treasury Department, explained to the Committee that there were severe constraints on a president as to when he could deal with such a proposal. He would not be able to devote the enormous amount of time and effort necessary to get a bilateral free trade treaty through Congress until other major domestic restructuring was in place. Any trade bill was a major undertaking and would arouse all kinds of protectionist elements. In Professor Bergsten's view, the appropriate legislative 'window' to push a Canada-U.S. trade deal through would be unlikely to open until the third year of the presidency.

Professor Bergsten added a second consideration with regard to the timing of a Canadian overture. Observing in April 1981 that the U.S. dollar was overvalued vis-à-vis the major European currencies, he expressed the opinion that protectionist forces in the United States were usually strongest at times of exchange rate overvaluation. This led him to conclude that the U.S. manufacturing sector might be more responsive to a Canadian free trade proposal at a time when the U.S. dollar was not overvalued in foreign exchange markets.

Reactions of the U.S. private sector

a) Business

Mr. Julius Katz, a U.S. businessman and formerly senior economic adviser in the State Department, considered that a Canada-U.S. free trade agreement would be "generally welcomed" in the United States. Initially U.S. viewpoints on this subject were rather naive, but there are now more reasoned views that the advantages of closer trade ties would be substantial, he said. They take different forms depending on particular economic interests.

This opinion appears to reflect the results of a number of recent studies made by private U.S. associations examining the North American economic and business relationship. These studies include those by the U.S. Chamber of Commerce, the Economic Policy Council of the UNA-U.S.A., the

Canadian-American Committee, the Conference Board and the U.S. Chemical Manufacturers Association. In addition, an extensive survey of U.S. industry sponsored by the Council on Foreign Relations and the International Management and Development Institute in 1980 sought the views of U.S. businessmen on the appropriate directions for U.S. foreign policy, including trade policy.

In general, the results are in favour of freer trade. None of these studies presses whole-heartedly for bilateral free trade with Canada, but in many cases U.S. business executives appear to see advantages in pursuing closer bilateral ties. As well, there are some sectors which would be opposed or would be indifferent. There was some anticipation of competitive and adjustment problems. Most groups considered the idea of a three-country, Mexico-Canada-United States, free trade area as "premature" with the conclusion that the U.S. government would need to continue to deal with its neighbours separately on a bilateral basis at this time.

On the whole, the idea of an arrangement with Mexico raised far more apprehensive reactions in the private sector than an arrangement with Canada, mainly because of concern over cheap labour. In general, U.S. executives showed a preference for a free trade approach rather than a European Community common market-type arrangement which allows the free flow of capital and labour across the borders.

It is obvious that the idea of a bilateral trade arrangement does not arouse the same kind of interested debate in U.S. business circles as it does in Canada. On the one hand the economic benefits to the American producer are generally projected as being less than for the Canadian producer. On the other hand, the threat of dislocation is also less, so there is little need for concern. U.S. companies trading abroad, because they are larger, tend to have a wider vision than comparable Canadian companies.

Even in areas where there could be distinct mutual benefit, such as in the petrochemical sector, not much interest has been shown by the U.S. companies, a distinct contrast to the keen interest shown by the Canadian petrochemical industry in gaining access to the U.S. market. (See page 55). However, Dow Chemical, a major U.S. producer has spoken out in favour of bilateral free trade and both Dow and Union Carbide, another U.S. petrochemical company have organized agreements with Canadian companies to increase the importation and marketing of Canadian petrochemicals in the United States.

But most U.S. companies in other sectors seem not to have focussed on the question. In fact bilateral free trade is an issue many American business leaders have not thought closely about. As a result very little impetus for it is likely to come from the U.S. private sector, making somewhat more difficult

the marshalling of necessary Congressional support by the Administration if it decided to embark on this route.

b) Labour

The reaction of U.S. labour groups is likely to be more hesitant. As Mr. Krause pointed out:

“U.S. organized labour might raise some objections, even though Canadian wages are not much below those in the United States and would be expected to rise to U.S. levels fairly soon. Nevertheless, U.S. unions might recognize that with enhanced investment opportunities in Canada, a great deal of capital would be attracted northward and not be invested in the United States. Thus with less capital at home, productivity and real wages would rise less.” (7:9)

The AFL-CIO labour leaders to whom the Committee spoke in Washington had not seriously considered the idea of a Canada-U.S. free trade arrangement. Their initial reaction reflected concern that a liberal free trade pact could be used as a precedent for further liberalization with Mexico, a result feared because of the wide wage-rate differentials between Mexico and the United States. There was some speculation that, under a bilateral free trade agreement, the unions in both countries would press for wage parity with the United States, denominated in national currencies. The U.S. labour leaders however considered that the fraternal links between many unions in Canada and the United States would smooth out difficulties.

Reaction of individual States

The reaction of the States to the idea of a closer North American trading arrangement would appear to be positive according to a survey conducted by the National Governors' Association on behalf of the Trade Representative's Office for its report. There was a realization by the States, said the report, that a more formalized trade relationship with both Canada and Mexico would facilitate the States' efforts in developing trade relationships and mechanisms.

Initiative from Canada

The initiative for a free trade agreement would have to come from Canada. This was the viewpoint unanimously expressed by all the U.S. witnesses to whom the Committee spoke. The main reason was that if the United States were to suggest such an arrangement first, the response from Canadian nationalists could be so negative as to strangle such a proposal in its infancy. Mr. Lawrence Krause said:

“At the outset, it should be clear that a serious initiative can and should only come from Canada and not from the United States. . . So, Canada must display considerable interest in promoting such a scheme to permit the United States the leeway it needs for giving it serious consideration. To reverse this process would likely kill the idea, regardless of its merit.” (7:8)

The Trade Representative's report on the subject of North American trade liberalization revealed a similar sensitivity.

"U.S. should not appear to be unilaterally stressing trade agreements since U.S. intentions might very well be misconstrued as an instrument of aggressive energy sourcing policy." (p. 83)

From the international point of view as well, it was pointed out that other GATT partners might be more inclined to interpret an initiative from the Washington side as a more threatening consolidation of North American economic power than if the proposal came initially from Canada.

Conclusion

It is evident that bilateral free trade would not come as a totally new idea to the Administration which itself appears to have been toying with the concept of some sort of broader trading arrangement with Canada. Despite the abrasive bilateral relations aroused during 1981 by certain Canadian policies as well as by Congress' failure to ratify the East Coast fisheries treaty, it might even be cautiously concluded that there already exists a receptive audience in certain Administration circles for a free trade initiative from Canada.

The argument that a bilateral free trade arrangement would avoid what appears to be the likelihood of increasingly abrasive bilateral trade confrontations with Canada could be an argument which would appeal to the U.S. Administration. Moreover, in a less eminent international economic position than previously, the United States might entertain the idea of an economic strengthening on a regional basis, particularly in the face of repeated frustration in certain of its multilateral trade liberalization moves.

A large segment of the U.S. business sector has been peppered with recent questionnaires and studies concerning their reaction to such a proposal, so they too are unlikely to be caught completely unaware. Undoubtedly there would be difficulties. Such an arrangement would create problems for particular U.S. industries and there would be difficulties in reconciling the U.S. preference for letting market forces prevail with the Canadian preference for safeguards to ensure employment and production levels. Nonetheless a considerable number of U.S. policy-makers could be expected to share the viewpoint of Mr. Julius Katz, who told the Committee that "a political and legal commitment by Canada and the United States to achieve the broadest possible free trade by a certain date, with appropriate adjustments to adversely affected interests would. . . represent an act of political vision and courage."

In balance, the evidence left the Committee satisfied that a Canadian initiative for a bilateral free trade agreement with the United States would be favourably considered by Washington.

PART III

A. The Economic Impact of Free Trade

1. General impact

What will the benefits be for Canada from free trade with the United States and what will the costs be? Contrary to what might be expected, it is the smaller country which is likely to benefit more in a move to bilateral free trade, not the larger one, according to economists on both sides of the border.* At the same time, it is recognized that the short-term adjustments will be more difficult for the smaller country.

Canada would face two types of economic impact from free trade with the United States. First is the impact stemming directly from the mutual removal of tariffs and non-tariff barriers. This would involve lower-priced goods for consumers, some gains and some costs in diversion of trade from other countries to the United States, as well as the removal of the often costly distorting effect of non-tariff barriers. When the lower consumer prices, the trade diversion and creation effects and the relief from non-tariff restrictions are added up, it has been estimated that the net effect is positive, albeit fairly small.

* The main reason why this usually happens, the Professors Wonnacott pointed out in a recent article, is that "trade allows a country to achieve gains by exchanging goods at international price ratios that differ from domestic price ratios it would otherwise have in isolation. And the larger the country, the more its domestic price will influence world price (i.e., price between partners); in other words, the less it will have to gain from free trade". Wonnacott, Paul and Wonnacott, R.J., "Free Trade Between the United States and Canada: Fifteen Years Later." March 1980. pp. 37-8.

Second, and in the long run more important for the future viability of the Canadian secondary manufacturing sector, are the gains achievable under bilateral free trade stemming from alterations in production processes. In particular, problems associated with the 'miniature replica' industrial structure built up behind protective tariffs—small plants, short production runs, managerial inefficiency and a lack of product innovation—would be reduced. With a large new market accessible to it, much of the Canadian manufacturing sector would be compelled to restructure, rationalize and specialize, thereby upgrading its efficiency to international standards to the benefit of workers and entrepreneurs alike. The opportunities seized by European companies within the European Community are an illustration of what is possible. Various estimates have been made of the gains to Canada from potential increases in productivity, and they are generally expected to be significant—up to eight percent of GNP, according to Professor Ronald Wonnacott.

It is important to note that the dislocating effect of bilateral free trade would be confined mainly to Canada's secondary manufacturing sector. For the primary and resource-related processing industries, trade is already largely free of tariffs, aside from the important exception of the Canadian petrochemical industry. In most cases, these industries are already rationalized; they are export-oriented and they have proven themselves efficient and internationally competitive. Free trade would cause few disruptions in this sector. At the same time they could enjoy additional benefits, such as increases in productivity from cheaper manufactured inputs that are still subject to tariffs. Increases in upgrading of Canada's resources could be expected as U.S. tariffs and quotas against processed primary products were eliminated. However the extent of this further processing would depend on Canadian competitiveness, additional transportation costs and the need for market proximity. Resource-related industries could also benefit from the ability of Canada to get behind the U.S. administrative wall to help deal with non-tariff obstacles to their exports. Witnesses told the Committee that the guarantee of a large internal market would reduce the risk of the huge investments needed in Canada's capital-intensive resource industries and an investment boom was predicted in this sector in a Canada-U.S. free trade area. In a bilateral free trade situation, it was suggested, output would increase in the following resource-based industries: mining, smelting, ferrous and non-ferrous metals, lumber, pulp and paper, non-metallic minerals, petrochemicals, fertilizers and some chemicals and primary and secondary energy industries.

The situation differs in the secondary manufacturing sector, however. Here the process of adjustment would generally work as follows. With the removal of tariff and non-tariff barriers to both northward and southward trade, Canadian manufacturers would be faced with not only the opportunity of greater market access to the United States, but also the threat of increased

competition from larger, typically more specialized, U.S. firms. This combination of market forces would compel Canadian firms to increase their output of each product, while narrowing the range of products produced. In order to continue operating profitably, many Canadian firms in order to survive would be forced to specialize in their most efficiently-produced products. Production costs would then decline as machinery changeovers became less frequent and employees' experience in individual tasks accumulated faster.

The significant point to note is that increased efficiency derives from product specialization, not plant size. Dr. David Dodge, the director of research, Institute for Research on Public Policy, pointed to a phenomenon which would be of benefit to Canada in moving to free trade.

"... the necessity for scale is somewhat less important to some industries today than it was even as recently as ten years ago. . . . Indeed, it is possible today to produce the same products in somewhat smaller plants than those used five years ago because of electronic controls and sophisticated servo-mechanisms."(1:10)

One of the persistent questions asked about a move by Canada to bilateral free trade with the United States is what would happen to investment decisions. Would business investment tend to take place in the United States rather than Canada; would Canadian producers not tend to locate production facilities in the larger market? The Hon. Larry Grossman, Minister of Industry and Tourism of Ontario expressed his concern in this respect to the Committee. Certainly, the spectre of Canadian companies packing up and setting off for the sunny southwest does little to enhance the political acceptability of free trade. The moves of some Canadian companies, particularly several very large developers determined to profit from new opportunities associated with the gradual move of the centre of U.S. population and industry to the south and west have dramatized a new Canadian problem which is developing whether or not Canada moves to bilateral free trade.

Corporate investment decisions involve a great number of diverse variables in addition to the specific concerns of climate and regional growth rates of population and economic activity. In practice, the fundamental investment criterion is simply efficiency, which includes in varying proportions, depending upon the industry in question, all of the following factors: availability and cost of labour, raw materials, financing and transportation services; effective rates of taxation applicable to the particular project in all its stages; education, vocational and recreation facilities; and energy supply, as distinguished from and in addition to other raw materials' availability. Overall efficiency is more important than any narrower concerns, and this is likely to prevail all the more strongly in the absence of official—artificial—barriers to trade. The effect on investment of the removal of tariff and non-tariff barriers would involve flows in both directions across the border, witnesses pointed out.

While Professor Weintraub considered that further analysis needed to be made on the question of whether investment would gravitate to certain areas of the United States or Canada, he stressed that other free trade arrangements between developed countries had not led to such a polarization of investment. Further, he pointed out, Canada has a skilled labour force able to man sophisticated industries, good transportation facilities and its main industrial capacity is close to large populations and markets in the northern United States.

The Committee considers that there is no reason to expect the aggregate net flow of investments to turn southward as a result of a bilateral free trade arrangement.

The pull of the United States is there whether free trade exists or not. In 1980, Canadian companies undertook larger investments in the U.S. market than in any previous year in history. A number of successful and innovative Canadian manufacturing companies such as Bombardier, Northern Telecom and ATCO, told the Committee that they had found it necessary to establish manufacturing divisions south of the border. Like many companies they have found the Buy American legislation, the U.S. federal 'set asides' for small businesses, and the restrictions on speciality metals to be insurmountable obstacles. Far from tariffs and non-tariff barriers stopping Canadian firms from moving south, they constitute a major reason for doing so. The status quo offers no protection.

The Committee considers that a bilateral free trade arrangement to protect Canadian exporters from these U.S. obstacles to exporting should slow the current move by Canadian manufacturing multinationals to locate facilities in the United States by eliminating a major reason for doing so.

Quite apart from the 'polarization of investment' question, there is no doubt that some companies would not be able to become sufficiently efficient and would contract or disappear. Adjustment assistance would be required to ease the painful economic and social dislocations thus caused. In respect to the extent of this dislocation effect, however, the result of a membership survey by the Canadian Manufacturers Association (CMA) was of considerable interest and quite encouraging. In preparation for testimony before the Committee, the CMA asked its large membership what impact Canada-U.S. free trade would have on their companies. The results are remarkable, bearing in mind that almost 80 percent of the CMA's membership is located in Quebec and Ontario and that by far the greatest number of respondents (81 percent) were smaller companies in secondary manufacturing with sales of under \$50 million, most employing less than 100 people.

In response to the CMA questionnaire, one-third of the member companies replied that they considered they would expand in a bilateral free trade

agreement, one-third said they would register no change, and one-third said they would have to contract. Further analysis of the survey revealed that companies which do not export perceived themselves to be more vulnerable to contraction while companies with a large export orientation felt more capable of surviving. The size of the company did not appear to make a noticeable difference; both small and large companies indicated they would do well or not do well.

In the light of the survey results, the Committee and a number of subsequent witnesses were puzzled at the conclusion drawn by the CMA, namely that bilateral free trade was premature. With a one-third, one-third, one-third tally, it hardly seems justifiable to assume that the neutral one-third which said it would neither decline nor expand should be associated with the declining group. It could just as easily (but equally inappropriately) be counted with the positive expansionist group. The survey was, in effect, a draw. But, as several witnesses have since emphasized, the response to a similar questionnaire only a decade earlier would almost certainly have produced an overwhelmingly negative response. The change surely indicates a movement towards a more confident and competitive position vis-à-vis U.S. industry.

Moreover, if the 10 percent of the larger responding companies which have sales over \$50 million had been appropriately weighted as to volume of sales (justifiable in economic terms), the Committee considers the survey results might have been overwhelmingly favourable to free trade. In addition, a growing positive attitude to free trade in the small business sector was noted by the Committee as early as 1977 when the Canadian Federation of Independent Business submitted a questionnaire to its huge membership as to how small businesses would react to free trade with the United States. From over 10,000 replies it had received, the Federation reported to the Committee at the time that just under one-half supported the free trade idea. Even in 1977 this result seemed unexpectedly confident.

Indeed the Committee was impressed by the optimism and confidence displayed by Canadian businessmen responding to a policy change of this magnitude. As Mr. Laurent Thibault executive vice-president of the CMA pointed out, jumping into the very large North American market for a typically small Canadian manufacturer represents a one thousand percent decision, whereas for a typical U.S. company adding the small Canadian market is only a 10 percent decision. It seems evident from the strength of the positive replies to both questionnaires that there has been a growing appreciation by Canadian business of the realities of the international competitive outlook and of the path which Canadian business should follow.

While the Committee heard from some manufacturers, for instance furniture producers, who urged continued protection of the Canadian market, it

heard many who were positive in their reaction to bilateral free trade with the United States. Mr. C.D. Reekie, president and chief executive officer of CAE Industries Ltd., was sympathetic that some Canadian manufacturing industries would be in difficulties if all bilateral trade barriers were eliminated. But he said, "the pill will have to be swallowed eventually and better sooner than later." For his own company, his attitude was tough and unpromising.

"There are CAE divisions which export into the United States now despite tariffs, and which sell in the domestic Canadian markets which are protected by substantial tariffs . . . There is no doubt that bilateral free trade with the United States would open up additional markets in the United States to these companies, and provide additional competition for their products in Canada from American suppliers who cannot now overcome the tariff advantages we enjoy. Generally speaking, we have to contend with a five to seven percent tariff into the United States, while they must overcome a barrier of 15 to 17.5 percent . . . I firmly believe that these CAE companies, too, should be prepared to compete for the total business available in North America. If they cannot exist without tariff protection and all other factors are equal, they will likely not prosper." (15:13)

Similarly, the heads of Westinghouse Canada, Spar, de Havilland, McDonnell-Douglas, Litton Systems and Canadian Marconi welcomed the idea. Admittedly a number of the witnesses who were in support were already benefitting from free or almost free access in the U.S. market. Their message was "Come on in, the water's fine." Mr. John Simons, vice president of Canadian Marconi, put it this way:

"The experience of Canadian Marconi Company in its trade with the United States shows, I believe, the substantial opportunities which are available in freer trade between Canada and the United States . . . Canadians are all too prone to want to retreat behind protectionist walls. All this has done is to perpetuate non-competitive industries, to foster a stagnant secondary manufacturing sector, and to cause the Canadian consumer to pay more for most goods and services. Only by re-orientating Canadian thinking to an international viewpoint and negotiating opportunities for freer trade with our trading partners will we develop industries which will have the comparative advantage necessary to succeed on a world scale and redress our current horrendous imbalance in trade of manufactured goods." (12:41)

In the Committee's opinion there has been a remarkable growth in self-confidence in the Canadian business milieu in respect to the question of bilateral free trade which has not yet permeated the political scene.

2. Which industries will expand? contract?

The Committee did not make a thorough examination of the benefits and costs of a bilateral free trade arrangement in all Canadian industrial sectors. On the basis of the evidence it received, the Committee is in a position only to point to certain highlights and to comment on selected industries.

a) The petrochemical industry

The Canadian petrochemical industry, a subject on which the Committee received considerable testimony, has the potential to play a key economic role in Canada's future. Seizing advantage of an assured feedstock extracted from natural gas, the petrochemical industry in recent years has spent or has plans to spend \$6 billion establishing world-scale plants. In the early 1970s, prior to this enormous expansion, the average size of Canadian facilities was only one-third to one-fifth that of American, European or Japanese competitors—small scale plants built to serve the Canadian market almost entirely. The result was high prices for the Canadian industrial consumers downstream. The future looked bleak; there was little chance to export and there was an inadequate return on investment. In the words of Mr. Clifford Mort, Chairman of Dow Chemical, Canada, the companies had the alternative either to “build world-scale, world-competitive facilities, or see their existing businesses die”. The companies took the major risk involved and invested heavily in new facilities designed to serve both the Canadian market and export markets.

Unfortunately the Tokyo Round did little to open up the market, particularly the U.S. export market, for derivative petrochemicals. In fact, according to Mr. B. G. S. Withers, vice-president of Petrosar and Mr. Clifford Mort, the U.S. barriers were increased rather than decreased. By 1987, under the Tokyo Round agreement, the average effective Canadian tariff on petrochemicals will be at 9.5 percent and the comparable U.S. tariff at 10.1 percent while the tariffs on certain important derivatives will be much higher.

Meanwhile the Canadian industry has geared up for the export market and by the mid-1980s it will be heavily export-oriented. What is critically important now, the Hon. Hugh Planche, Minister of Economic Development of the province of Alberta, told the Committee, is guaranteed free access to the U.S. petrochemical markets. Already in 1980, Canada had for the first time a small trade surplus in petrochemicals—a turnabout from the \$500 million deficit of 1977—as a result of a combination of a favourable exchange rate, high market demand and very competitive oil and gas prices in Canada. Currently the industry has a capacity 25 to 35 percent higher than Canadian market requirements.

Moreover, the industry itself is broadly united in its need for bilateral free trade in petrochemicals. Mr. R. L. Pierce, president, Alberta Gas Ethylene, told the Committee that, while the industry had put out “an uncertain signal” at the time of the GATT negotiations which effectively eliminated any chance of securing concessions in this sector, it is now no longer divided on the issue. Rather, it is convinced of its “unique opportunity.” The Hon. Hugh Planche later stressed the considerable urgency for the Canadian

industry to use its present "window in time" to establish economies of scale at each level of upgrading before competitive Middle East installations come onstream.

The prime importance to the whole economy of an expanded petrochemical industry was emphasized to the Committee. In a written submission, Mr. T. E. Newall, chairman, DuPont Canada, stated that in the United States, studies have indicated that the U.S. petrochemical industry has an important spillover stimulus on business sales, capital investment and employment. In Canada, where oil and gas supplies are more significant, in relative terms, to the economy, the impact of an expanding petrochemical industry could be even more positive than in the United States. Mr. Withers estimated that bilateral free trade might result in double the upgrading done in Canada. Indeed, recently, Union Carbide, a U.S. company, concluded a major agreement with a Canadian company, Enesco, to purchase polyethylene resin to be produced in a large new plant in Alberta.

In elaborating on the job creation potential of upgrading petrochemicals, Mr. Mort said that if ethane, the basic feedstock of natural gas is given the value of 1, upgraded to ethylene it is 4, upgraded further to the first stage derivative it is 28, for polystyrenes it becomes 46 and by the time these products are moved to the fabricating industries, such as plastic moulders, there are 1,000 jobs created for every one job extracting ethane. If bilateral free trade resulted in this industry moving even half way up this upgrading scale, consider the huge numbers of new jobs which would be created in Canada. On the subject of further upgrading Mr. Pierce added that Canadian downstream producers in the processing and fabricating industries have been inhibited for years in their development because they have had to pay a premium price on locally produced petrochemicals. Mr. Newall said that his firm has been a world pioneer in the production of linear low-density resins and its polyethylene resin business would benefit in a major way from bilateral free trade in petrochemicals. He added that "if limited to the domestic market, we would have to sell to end-use applications where our specialty resins have no particular added value. In the huge North American market, on the other hand, the scale would be such that we could retain and develop our specialties to the fullest extent possible."

While Mr. Ian Rush, president of Polysar Limited, indicated in a written submission that his firm was favourable to the bilateral freeing of tariffs for primary petrochemicals and derivatives, he raised the additional important point that for a truly free market in petrochemicals, some arrangement would be required regarding non-tariff measures.

Canadian producers have been careful to point out that increased Canadian petrochemical exports would not undermine the U.S. industry, that it would be the late 1980s before Canada could achieve a 10 percent penetra-

tion of the U.S. market and that since that market would be growing during that period, the 10 percent would represent only about one to two years' growth in the market. The U.S. Administration for its part is sensitive to another problem, that is, the fact that the Canadian feedstock price is lower than the feedstock price available to U.S. producers, although currently the U.S. Gulf Coast states producers also have a controlled lower-than-world-market price. Most Canadian producers contend that a feedstock price at 85 to 90 percent of the U.S. price is necessary because of higher capital costs, higher distribution costs and higher construction and maintenance costs due to location and climate. However, the Hon. Hugh Planche said that studies made by the province of Alberta on petrochemicals had not been predicated on a discount price. He thought security of supply would induce long-term investment.

The benefits to the petrochemical industry of free access to U.S. markets are clear and the industry itself is prepared. The advantages to the entire Canadian economy seem equally clear. But experience to date and testimony before the Committee in Washington indicated that there is no likelihood of making a free trade arrangement in this sector alone because the benefits would accrue largely to Canada. As emphasized by Mr. Jack Dewar of Union Carbide in his testimony as quoted on page 36 there is simply no easy *quid pro quo* to be found within this single industry.

For this reason the Committee stresses that only a broad approach to free trade, with a sharing of benefits and costs across many industries, holds the prospect of success. Only this course would give the petrochemical industry the boost it needs.

b) Secondary manufacturing industries

As stated earlier, under bilateral free trade the major negative effect would be felt by the secondary manufacturing industries, not by the primary and resource-related processing industries which should expand significantly. Within the manufacturing sector, the impact would vary widely.

A divergence of views was presented to the Committee by economists as to what would happen in the secondary manufacturing sector in a bilateral free trade situation. Opinions ranged from predicting an increase in Canadian secondary manufacturing output to anticipating a small decline overall in secondary manufacturing activity, more than balanced by a large increase in resource-related activity, including further processing. Witnesses were hesitant to speculate on the prospects for specific industries. Dr. David Dodge, a proponent of the more cautious approach, considered that output would be likely to fall in the following industries: food processing, beverages, tobacco, textiles and clothing, furniture, some metal fabricating, household appliances, hardware and tools, motor vehicles and parts, paints and

household soaps and toilet preparations. But he expected that output would increase in most of the resource-based industries and in some machinery industries, in the electrical and communications equipment industries, the glass industry and in a large number of service industries. Dr. Dodge said the importance of the so-called service industries should not be overlooked as business services represented a very high skill, high employment industry and one in which Canada has developed capability. In assessing the probable expansion of primary industries and the decline of certain secondary manufacturing industries, Dr. Dodge commented:

"... The skill requirement and the technology involved in a host of the primary industries in terms of primary upgrading is very much superior to some ... assembly-type operations. I would feel happy if we could find some [primary] industries to move in and some of the service industries to move in to replace the relatively low productivity industries, such as textiles which we have."
(1:20).

According to testimony from the Canadian secondary manufacturing sector itself, the consequences for specific industries would be mainly determined by two important factors: the economies of scale available and the relative transportation costs. Witnesses pointed out that when transportation costs are low—when a product travels inexpensively—and the economies of scale in production are high, production becomes centralized in the most advantageous location in relation to the total market. This could mean that certain production activity might move to the United States. On the other hand, products that are manufactured in shorter runs where economies of scale are low and where transportation costs are high might not be affected when trade is free. In between these two situations are a range of variations. Clearly, production of huge custom-made generators or turbines or other machinery with neither economies of scale nor low transportation costs would not tend to relocate; nor would metal fabrication which tends to be locally oriented and manufactured in small volumes for specific orders. Cement, notwithstanding its good levels of productivity and economies of scale, would not centralize production because transportation costs are relatively high.

In the CMA survey, the industries which were ranked the most confident of new possibilities in a free trade environment were the primary metal industry, the electrical industry, the non-metal mineral industry, the transportation equipment industry and the textile industry. They, and other industries which were satisfied they could expand, gave a variety of reasons which were summed up as follows:

"They relish their access to a larger market. They felt they would get better utilization of their facilities and, therefore, be more cost competitive; they felt they might get lower raw material prices and that would help them; they felt they could easily establish at least some kind of a little position in a huge market; they felt they might get lower machinery prices, which would lower their costs; they felt they might be able to bring in goods more cheaply to round out their product

lines; they felt they had a good geographical position; some of them felt they had better technology; and some felt they had specialized custom-made equipment and would be able to do well.” (14:55)

The CMA also identified the industries having the largest number of companies which were doubtful about bilateral free trade. The reasons given to the CMA by these firms, including subsidiary firms, which feared contraction in an open trading system were:

“They generally said that the bigger, more specialized, lower-cost, high-technology plants in the U.S. would simply do them in. They also argued that they had, generally, higher running costs in terms of wages and materials in Canada. That is the predominant reason. The second most important category of reasons, quite apart from the competition issue, was that they just simply said they would be unable to make a transition because they were not capable of making an autonomous decision in Canada, that they would have financial limitations, plant facilities would not be on par, and that they had licensing limitations on exports.”(14:53)

Surprisingly, under the CMA ranking system the paper industry appeared to be the most vulnerable, followed by textiles and chemicals. However, as Mr. Thibault of the CMA explained, the reason why the paper industry headed the list of doubtful industries was because the survey reflected mainly the viewpoint of numerous small paper companies, including fine paper companies, with annual sales of less than \$50 million. The major integrated paper companies which are already fully internationalized with large sales and employment would not be affected in the same way. Indeed, in the Committee’s view, these large paper companies would welcome bilateral free trade. The same is obviously true of the large petrochemical companies in contrast to small chemical firms which made up the bulk of the respondents in that industry. If the replies of the respondent paper or chemical firms had been weighted by volume of sales and number of employees rather than merely by the number of companies responding, a procedure which automatically gave extra weighting to the views of the numerous small companies, a more realistic assessment of the industry reaction might have been obtained.

The CMA testified that other industries in which a significant percentage of companies responded that they would contract under a bilateral free trade regime included the textile industry, the transportation equipment industry and the electrical industry. It is clear from a comparison of the overlap of these three industries with those industries ranked by the CMA as the most confident they could expand, that a distorted impression of industry reactions results from the equal weighting accorded each firm regardless of size, sales or employment levels. In each industrial sector which feared contraction, it is evident there was a significant number of large, confident, more efficient firms which considered they could expand under bilateral free trade.

In fact, as Mr. Thibault told the Committee, a significant amount of rationalization of manufacturing is already underway in Canadian and for-

eign-controlled companies as these producers recognize it is no longer profitable to make a large number of products with short production runs.

The furniture industry is a mixed situation. In testimony before the Committee a majority of the furniture companies' representatives were fearful of bilateral free trade or of any lowering of Canadian tariffs on furniture beyond the 15 percent level scheduled for 1987. (By contrast, U.S. furniture tariffs will drop to between 2 ½ and 7 ½ percent by 1987.) Mr. K. M. Campbell, expressing the point of view of the Canadian Council of Furniture Manufacturers, emphasized the higher labour costs, higher material costs, lower productivity levels and higher freight rates in Canada than in the United States. Mr. Bernard Papineau, president of H.P.L. Cie, pointed to the special constraints affecting Quebec furniture manufacturers, such as the smallness of the companies involved, the small-sized plants with their broad diversity of product lines, the lack of economies of scale and the high dependency of small communities on the furniture industry. Mr. Joe Malko of Furniture West Inc. of Winnipeg said that in the case of the furniture industry of Western Canada, the small, family-owned furniture manufacturing facilities were already very sensitive to competition from the U.S. furniture industry. For most Canadian producers, the strongest competition was cited as coming from the U.S. South, particularly North Carolina, where the lower wages of non-unionized workers give the U.S. manufacturers a competitive advantage.

However, in the CMA survey, almost as many furniture companies expected to expand as to contract in a bilateral free trade setting. Dr. James McNiven, then executive vice-president of the Atlantic Provinces Economic Council, did not think that the specialized furniture industry in the Maritimes would be particularly affected one way or another by bilateral free trade. Moreover, because of its vulnerability to damage in transport, living-room furniture is considered to have a considerable degree of protection. In addition, transportation costs which are relatively heavy for most furniture items could be expected to protect the Canadian market somewhat from distant southern U.S. products, while allowing Canadian producers in Ontario and Quebec a degree of advantage to nearby populated markets in the north-eastern United States. Some Canadian furniture producers, including office furniture producers, have already moved aggressively into the U.S. market, successfully competing over the U.S. tariff by specializing and rationalizing. It is difficult to understand why, in the face of gradually lowering tariffs and increasingly competitive imports, more rationalization and specialization is not taking place in this Canadian industry.

To sum up, bilateral free trade will undoubtedly mean some painful adjustments in the secondary manufacturing sector. But even at present, standard technology manufacturing companies, not of world scale or not tied to resource development, are finding it increasingly rough going. Many are

already being squeezed and the future outlook is not promising. **Bilateral free trade would allow Canada to concentrate more on things that it does well, including resource-based industries and certain secondary manufacturing industries where Canada has a natural advantage, to build on these areas and substitute these for goods which it produces less efficiently behind protective tariffs. The outcome could be an industrial establishment equipped to face the challenges of the 1990s. Canada would be better off in the end and certainly very much better off than if it continues its current policies.**

c) Foreign-controlled companies

In respect to U.S.-controlled companies, concern has been expressed that in a bilateral free trade arrangement, there could be significant repatriation of production to the United States, or even the outright closure of branch plants, leaving the Canadian market to be supplied from across the border. Having originally located in Canada to get access to the Canadian market behind the protective tariffs, subsidiary firms, it is argued, might consider they had no reason for staying once tariffs had been dismantled or reduced so much as to no longer constitute a barrier to imports from the parent company in the United States. This concern was mentioned in the Committee's 1978 report.

In its survey, the CMA found that foreign-controlled subsidiaries were slightly more vulnerable to contraction under bilateral free trade than Canadian-controlled companies (35 percent as compared to 27 percent). A company's reaction to free trade appeared to be more closely related to whether it exported than whether it was foreign-controlled; that is, the larger the export orientation, the more a company felt able to survive in a free trade setting.

It can be assumed that for many of these subsidiary companies, if they could not expand into export markets, survival would not be possible. Even under current conditions some subsidiaries are contracting and repatriating production to the United States, not as a result of bilateral free trade, but due to the lessening importance of the tariff and their own uncompetitive industrial organization. The Hon. Larry Grossman of Ontario, a province where half the secondary manufacturing industry is foreign-controlled, recognized this development when he told the Committee that the fact that tariffs were no longer important in many sectors, calls into question "the viability of branch plant operations... originally set up to jump the tariff walls".

A number of branch plant subsidiaries have already faced the fact of their outmoded structure. Their experience is instructive. Westinghouse Canada told the Committee that a private survey it made in 1978 of 50 U.S. subsidiaries in Canada, in the electrical and electronic industry, had revealed

that over half were increasingly concentrating on the export market. The necessary reorganization is obviously easier for a large multi-product company like Canadian General Electric (CGE) than smaller subsidiaries. Mr. L.R. Douglas, vice-president of CGE, told the Committee that his company had become a "product specialist" in 26 different products within the General Electric organization, including such major products as hydro-electric generators, jet engines, hydraulic turbines and paper-making machinery. In a bilateral free trade setting, CGE would restructure further, Mr. Douglas said. Some products now made in Canada would be supplied from the United States and the manufacture of other products would expand with tariff-free access to the U.S. market.

In 1977, Westinghouse, Canada, rationalized its Canadian production of lamp products on a North American basis. Faced with declining profits, the product lines made in Canada were narrowed down but the products still produced in Canada were now sold in the U.S. market as well as in Canada, and U.S. products were imported to Canada replacing the styles and types no longer made here. The result of this specialization, said Mr. F.H. Tyaack, president of Westinghouse, Canada, was increased efficiency, lowered unit costs and better total factory capacity in both countries. Although the duty on lamps coming into Canada is double what it is going into the United States, the company was determined to "blast through" the tariff to make its rationalization strategy work. This North American rationalization averted any thought of closing down the Canadian lamp products operations, Mr. Tyaack said.

It appears evident from such examples that a bilateral free trade environment could make reorganization easier and more attractive for subsidiaries of multinational companies.

In the late 1970s, Westinghouse went further and prepared a long-range plan for its Canadian subsidiary based on the assumption that no form of tariff protection existed whatsoever, no non-tariff barrier protection was available and the U.S. and Canadian dollars were at par. It was, said Mr. Tyaack, a "worst-case" scenario. The plan, which placed principal emphasis on world product mandates and other rationalization schemes, envisaged the export of half of Canadian production by 1990. With this strategy, the company had implicitly answered the question, "How would Westinghouse react to a free trade agreement with the United States?"

However, Mr. M.J. McDonough, the senior vice-president of the parent Westinghouse company, who testified along with Mr. Tyaack, also gave the Committee the explicit reasons why his company would not pull its production operations out of Canada in a free trade situation: its considerable investment and large trained work force, the company's long-term strategy for mutually satisfying business arrangements, the fact that Canadian

exports can be sold in markets to which exports from the U.S. company cannot, and the company's successful decision to restructure on the assumption that free trade already existed. As a result of rationalization, Westinghouse, Canada, has become highly efficient and actually more profitable than the company's U.S. operations.

Product mandating by subsidiary companies is increasingly regarded as an important instrument for countering the risk of multinationals repatriating production facilities. Under a global or North American product mandate, a subsidiary is given total responsibility within the corporate family for developing, marketing and exporting a specific range of products.

The Committee heard excellent evidence from four very successful subsidiaries which had sought and obtained product mandates from their parent: Pratt & Whitney, one of the first subsidiaries to use this formula, now has annual sales approaching half a billion dollars, mainly from its small turbine engine; Garrett Manufacturing has its temperature-control systems on 70 percent of the world commercial and military aircraft; Litton Systems Canada has its inertial navigation system in the aircraft of 70 airlines and has recently won a very large contract for a navigation system on the U.S. Cruise missile; Westinghouse Canada has the company mandate for industrial turbines, certain electronic products and airport lighting.

Repatriation of such successful subsidiaries by the parent appears very unlikely. In these cases, although every company is different, the evidence heard by the Committee revealed a very great degree of independence by the subsidiary in handling its own mandated product. There were frequently significant benefits accruing from the parent in the form of transfers of technology and marketing expertise.

For example, Mr. Ronald R. Keating, president, Litton Systems Canada told the Committee that through product mandating his firm had established a comparative advantage in a wide range of high technology products and would benefit from a free trade arrangement—bilateral or multilateral.

"Because of the advantages we have built up, we do not believe that a free trade situation would lead the parent organization to consolidate, in the U.S., production of our important lines." (15:25)

Mr. W.C. Tate, vice-president and general manager of Garrett Manufacturing had an interesting additional comment.

"The establishment of a highly technically oriented engineering group and facilities for production makes it far more difficult to move than it would for a branch plant operation which is not doing its own design or development or manufacturing in Canada." (15:16)

One of the effects of product mandates would be an increase in the R&D done in Canada by foreign-owned firms. Mr. Tyaack explained the different

attitude towards R&D of a branch plant and of a subsidiary with full responsibility of product lines.

"... one of our problems in doing R&D when we were a branch plant was, all right, we did the R&D; where are we going to dump it now that we have it? Because the market was too restrictive. There wasn't the entrepreneurial drive to do that much that was new for this market . . . It wasn't so much a question of a subsidiary manager having problems with the parent as it was an opportunity problem. Once you get into that hot competition in your world charter areas, then you have a worthwhile place to dump your R&D. We do not necessarily recommend that you crank up and do a lot of R&D and then let that somehow push its way into markets of strength. That is a long trip, and you may guess wrong at the R&D level because you do not know what the applications are." (16:20-21)

Aware of the potential of product mandating for strengthening and transforming branch plants, the Hon. Larry Grossman told the Committee he has established a joint government-industry committee to help push multinational parents into granting product mandates to Canadian subsidiaries. This group has already established a list of about 100 subsidiary companies with full or partial product mandates. Mandated products include: computer systems, muffler parts, antenna systems, carpets and rugs, pharmaceuticals, auto radiators, mining equipment, furnaces and auto brake products. Mr. Grossman mentioned that he was considering using provincial procurement preference and perhaps incentives to encourage product mandates in Ontario.

The Committee welcomes the current emphasis on product mandating insofar as it reflects increased awareness of the need for manufacturers to rationalize production in order to improve efficiency. But the Committee is concerned that the assignment of product mandates is being regarded in government quarters as a panacea, to be secured through offering sticks or carrots to Canadian subsidiaries of multinational companies. Not only is this potentially costly, but the approach implies that the achievement occurs in a static environment, like winning a race which ends. But the trading world is dynamic and the assignment within a group of companies of product mandates is a rational response to a market situation. Many of the successful instances of product mandating—Pratt & Whitney, Garrett Manufacturing, and Litton Systems—have occurred in the aircraft industry, where free trade already effectively exists. Or like Westinghouse, some companies have decided to act as though free trade exists, even though difficulties with tariffs and non-tariff barriers are present, as Mr. Tyaack explained.

"While we have decided to proceed with our plans, which are based on a total absence of protection, the fact is that tariffs and non-tariff barriers do exist. If anything, in terms of whether one perceives it from Canada looking at the U.S. or from the U.S. looking back at Canada, the latter seem to be increasing. Many of those can be a hindrance to us. Concerning tariffs, for example, as we increase north-south trade between parent and subsidiary, even if the trade is balanced we have to pay an increasing amount of tolls at the border, which diverts moneys we would rather have for investment. For those products that get involved in government procurements, we can actually be blocked from rationalization schemes due

to non-tariff barriers having to do with content or what have you . . . We see a tendency to proliferate these kinds of subtle barriers which do block such schemes as we have." (16:16).

The conclusion seems inescapable. Product mandating assignments and rationalization schemes within transnational firms are easier in a free trade setting, where tariffs would be eliminated and the application of non-tariff barriers mutually agreed to and enforced. However, a number of the success stories in world product mandating have resulted from federal financial assistance provided through PAIT (the Program for the Advancement of Industrial Technology) or DIP grants. It would be important to ensure that, under the terms of a bilateral free trade arrangement, subsidiary firms with potential would not be deprived of this type of assistance initially from the Canadian government, particularly since counterpart U.S. firms are also recipients of a variety of assistance in developing new products.

Repatriation and contraction of subsidiaries is an ongoing possibility, both at the present time and potentially under a free trade regime. **But to the extent that North American rationalization and product mandating are vigorously pursued by subsidiaries, the likelihood of repatriation is lessened.** As executives told the Committee, a parent company is much less likely to repatriate a technically-oriented engineering group with an efficient facility producing a successful product than to close down a branch plant operation manufacturing a similar product for a small adjacent market. Moving to freer trade in North America would create a dynamic new environment in which the potentially strong producers could and would grow and some of the weak would fall by the wayside. Subsidiaries would not wait to be assigned product mandates but, like Canadian Marconi, develop their own products in Canada regardless of the location of their ownership.

While the large foreign ownership component of the Canadian secondary manufacturing industry has been looked on by many nationalists as a disadvantage in the struggle to promote industrial development in Canada, in terms of restructuring it could actually be an advantage. Indeed, as Mr. Tyaack pointed out, rationalization schemes and product mandates are easier when the subsidiary is wholly-owned or almost wholly-owned, by the parent.

"Suppose . . . we were only 50 percent owned. In that case, if I propose to the parent that we produce something in an alternate plant site in Canada for sale in the North American or world market, rather than make the same product in the United States in an alternate plant site there, I could be at a disadvantage, because to make the product in the U.S. would avail Westinghouse of 100 percent of the fruits of such labour but to make the same product in Canada would only bring back 50 percent of the fruits to Westinghouse. We would be sharing with other owners something that historically we had developed ourselves. That could put the Canadian option at a two to one disadvantage. I bring that up only because I do not think that issue should be looked at as totally irrelevant to the issue of rationalizations and world product mandates between subsidiaries and parents." (16:17)

The Committee concludes that in a free trade environment, foreign ownership could be an asset, giving Canadian manufacturing facilities easier and more secure access to the large and competitive U.S. market. In this situation product mandating would become a rational intra-company response. Providing the Canadian economy remains generally competitive, massive repatriation and de-industrialization are not dangers.

d) High technology industries

Overlapping to a degree both the discussion of secondary manufacturing industries and foreign-controlled companies is the high technology sector, but its importance is such as to warrant separate consideration.

High technology industries offer the best future prospects for the Canadian economy. Mr. David Mundy, former senior trade official and past president of the Air Industries Association of Canada, drew the Committee's attention to a government study which has shown that high research intensive industries in Canada have out-performed, by a wide margin, those of low research intensity—higher employment by 50 percent; higher output by 23 percent; improved productivity by 29 percent; lower growth in prices by 57 percent. The viability and growth of this sector is critically important. What are the chances that this dynamic sector would move into the United States in a free trade situation? To what extent would it tend to gravitate toward clusters of 'high tech' industries south of the border?

To compete internationally in advanced technology is costly and it involves big risks. Innovative technology is enormously expensive to acquire, whether it is imported or developed in-house. Competitors in other countries are usually supported by massive government funding or other types of assistance. The most advanced technology and production methods are prerequisites. Concerned by the need for more innovative products, the Canadian government has been pumping out financial assistance through various programs to assist key high technology firms to do R&D in Canada.

Yet, by and large, the sectors which have produced the most fruitful results to date have been those which can sell their products in other markets, particularly the United States. The aerospace and avionics sector is the prime example. While government assistance in innovating has been important, the essential component in their success has been market access. Mr. John Simons of Canadian Marconi told the Committee:

"In those market segments where free or nearly free trade exists, Canadian Marconi has been able to compete, grow and prosper. In those areas where free trade does not exist, Canadian Marconi has made no significant sales." (12:41)

The same approach was stated by the president of Pratt & Whitney, Mr. E. L. Smith when he asserted that "there is no possibility at all of surviving based on the Canadian market alone". The Defence Production Sharing

Arrangement (DPSA) and the GATT Trade in Civil Aircraft Agreement have permitted the success of many of Canada's foremost aerospace firms. Companies such as Canadian Marconi have flourished in Canada, selling more than twice as many avionics products in the United States as in Canada. A multi-product company like CAE can sell flight simulators and magnetic detection equipment under the DPSA or the civil aircraft agreement. It can also, under the auto pact, export duty free its advanced technology parts to the United States. In each case the key to the success of innovative products has been free access to the U.S. market.

The Hon. Patrick McGeer, Minister of Universities, Science and Communications for the province of British Columbia, told the Committee that he has had direct experience with international high technology firms which decided not to establish a facility in Canada because they did not have the whole North American market base in which to operate freely; that is, no guaranteed free access to the U.S. market from Canada. Mr. McGeer also cited the case of a thriving Canadian pharmaceutical firm which had built its plant in the United States because of U.S. tariff barriers in order to exploit its Canadian discovery. The U.S. part of the Canadian company soon became dominant and sold out to a U.S. firm. Had it not been for the U.S. tariff, the company would have remained in Canada. In addition, some of Canada's successful high technology companies, such as Northern Telecom, have established manufacturing divisions south of the border in order to get assured market access around non-tariff barriers such as Buy American legislation, small business 'set asides', restrictions on the import of specialty metals, etc.

Far from fearing the massive relocation south of the border of Canadian high technology manufacturers, the Committee is convinced that such firms would do more R&D in Canada and would be more likely to flourish in a free trade setting which eliminated the tariffs, limited the application of non-tariff barriers and removed the inducement which now exists to locate manufacturing facilities in the United States.

B. Regional Economic Impact

1. Political perspectives

The tariff has been a source of regional friction in Canada for 100 years. For most of that time, free trade with the United States has been strongly supported by Canadians in the West and the Atlantic provinces and just as strongly resisted by Canadians in the central provinces. The rationale has been that with free trade, people in the extremities would benefit from cheaper imported consumer goods and find a readier market for their own

products—which in the case of resources, could be upgraded prior to export—while people in Quebec and Ontario were concerned to establish a protected market for their manufacturing industries.

This historical pattern was, to a certain extent, borne out by the viewpoints of the regional representatives who testified before the Committee. For example, the Hon. Patrick McGeer of British Columbia told the Committee that Canada has been pursuing a foreign trade strategy that has caused the country to forego significant economic opportunities. He said Canada's "manufacturing strategy is particularly disadvantageous to the wings of the country—by that I mean the West and the Maritimes." He continued:

"The defensive strategy is one that accepts or encourages reciprocal tariffs as a means of isolating Canada from foreign competition. . . in the name of nationalism. The other side of that coin is the one that traditionally has been so hard for westerners to accept, namely the denial of opportunity to Canadian manufacturers, because of the reciprocal tariffs, to penetrate the much more lucrative markets which exist in the United States, traditionally, and now in Japan and the European Economic Community." (20:7)

And he argued further:

"How then do we offset the foreign deficit that we have in manufactured goods? We offset it because of our surplus in the area of unprocessed natural resources. These come in disproportionate measure from the West. So here you have the source of historic western alienation. Westerners are obliged to buy their manufactured goods from eastern Canada, where the prices are above world market prices, because the branch plants cannot operate here as efficiently as they can in other parts of the world. So westerners buy Canadian manufactured goods at high prices. At the same time, they sell their resources, always unprocessed, often non-renewable, at world market prices." (20:7)

All in all, an excellent expression of the classic Western position on tariffs and the protectionism of the central provinces.

Alberta's position was similar. Alberta was seeking "general trade liberalization with the United States," said the Hon. Hugh Planche. He continued:

"We are a relatively strong and rapidly expanding economy. In order to achieve world scale economies we must pursue the most lucrative volume markets available to us. This requires that Alberta have free access to the large U.S. markets for its products. Therein is the basis for our objective of free trade." (21:11)

Moreover, while Mr. Planche did not explicitly endorse a broadly-based bilateral free trade agreement, his attitude was positive.

"We are unable to see anything that would be troublesome in terms of opening free trade with the U.S. . . . Almost all sectors of our industry—in fact without exception—would benefit from economies of scale and market access." (21:12-13)

The Hon. Robert Stanfield, a former premier of Nova Scotia, reaffirmed the opinion that bilateral free trade would be of benefit to the Atlantic region, and as he stated "the evidence suggests that we are having difficulty

competing because of the size and scale our competitors are able to operate on owing to the size of the markets they have access to".

A more muted viewpoint was expressed by the Hon. Roland Thornhill, Minister of Development in Nova Scotia who, while acknowledging the historic Atlantic viewpoint that the Canadian tariff nullified the advantages of geographic proximity of the Maritimes to major U.S. centres of population, went on to say that "factors including international trading patterns and cost competitiveness, reduced tariffs, fluctuating exchange rates and technology are making the advantages of the Nova-Scotia-New England economic link much less clear-cut and constant both for the consumer and the exporter". Further, he considered the benefits to the consumer could not be considered "in isolation from the domestic industrial base from which the consumer derives his livelihood and purchasing power". He expressed concern for the small to medium-sized provincial industries "which have declared themselves vulnerable to import penetration in the event that import barriers were lifted." He mentioned particularly companies specializing in paperboard, linerboard and moulded pulp products, as well as the textile and clothing sectors.

Dr. James McNiven, at the time of his testimony executive vice-president of the Atlantic Provinces Economic Council, said that many of the smaller businesses in the region have been created and maintained by "a combination of tariff factors, distance-related costs and a cheap dollar." These might disappear with free trade, he warned, and small engineering firms and consumer product manufacturers could be adversely affected. Further, he was concerned as to how free trade might affect the region's non-tariff measures to protect local industries. Dr. McNiven went on to say, however, that his overall assessment of the impact of bilateral free trade in economic terms was "the potential benefits to be gained . . . appear to be larger than the risk of what might be lost." He recognized that certain large manufacturers in the region could be helped by free trade and he doubted that the area's furniture producers would be negatively affected. Some moderate expansion could be expected in the resource sector, largely fish and forest products, with some increased upgrading. In this respect, Mr. Hal Connor, former chairman of National Sea Products of Halifax, testified in 1980 that bilateral free trade would be likely to lead to expansion of the market for prepared fish products.

The central Canadian position toward freeing of trade as expressed by the Hon. Larry Grossman, Minister of Industry and Tourism of Ontario was extremely cautious. Mr. Grossman attached importance to Canada remaining competitive and an attractive location for investment; he readily agreed that "non-tariff barriers are the fundamental issue"; he admitted that "the practical, realistic absence of tariffs . . . is calling into question the viability of branch plant operations" and that "the challenge then is to restructure

those plants"; he indicated that his "preferred route" was for cross-border rationalization in specific sectors and he urged Canadians to come to grips realistically with the fact that in certain sectors or industries, the idea of trying to build "world class industries based only on the Canadian market will not succeed and in those sectors we must seek other alternatives."

Mr. Grossman was opposed to an 'across-the-board' approach to bilateral free trade with the United States favouring instead the "attempt to reach bilateral agreements on the use of procurement practices in particular sectors. Urban transit equipment would be a good place to start." However he appeared to overlook the fact that two efforts since 1977 to interest the United States in such arrangements have provided no results.

The Committee noted that Mr. Grossman's rejection of bilateral free trade was based on a perception that this would involve "drop(ping) all rules and have(ing) a total unrestricted, unfettered, unstructured free trading area with the United States." No wonder Mr. Grossman is opposed to bilateral free trade. And while this is not the place to question Mr. Grossman's understanding of what free trade would involve, the Committee must restate that a major reason for its support of free trade is precisely because this approach offers the most promising avenue for negotiating mutual exemption from each other's non-tariff barriers which Mr. Grossman says are a principal concern. Nor would the agreement be 'unstructured' or 'unfettered'.

In sum, the Committee observed that although there has been some shift in position, traditional attitudes of provincial spokesmen have not changed all that much. And regional tensions relating to them still exist.

The Hon. Robert Stanfield, apart from his testimony as quoted above, had a broader approach. As one highly qualified to assess the problem both from a regional and a national perspective, he looked at the issue from all sides—the regional disparities, the competitive disadvantage of the Atlantic region and the West, the undersized Canadian market, the lack of economies of scale, the need for access to the U.S. market and the shortcomings of GATT solutions in this situation. He told the Committee that a reciprocal tariff-free arrangement with the United States "could not only open up new opportunities for Canadian manufacturing but could significantly reduce regional tensions in Canada". In view of the serious difficulties facing the Canadian manufacturing industry, he considered that access to the larger market "seems to offer the only hope of reducing one basic cause of economic disparity in the Atlantic region, and perhaps, one grievance . . . in the west—the definite disadvantage in competing in Central Canada in the Canadian market". In a larger trading area, he said "the western provinces and the Atlantic provinces might well be in a much better competitive position, and be at less competitive disadvantages compared to central Canada . . ."

Mr. Stanfield pointed out that Canadian industry appeared to be efficient and competitive where it has tariff-free access to the U.S. market. Where would the newsprint industry in the Maritimes be if newsprint had not had tariff free access to the U.S. market? Would it exist if it had had to depend substantially on the Canadian market, and to compete with newsprint plants located in the central and other parts of the country, he asked?

Mr. Stanfield indicated he was aware of the political difficulties involved and the dislocation effects on industry, but he nevertheless reiterated that free access to the U.S. market

“might very well help all regions of Canada . . . In the sense that it reduced, if not eliminated age old grievances by Maritimers and others trying to compete in the Canadian market, I think it might very well reduce inter-regional tensions in Canada.” (5:9)

In the Committee’s opinion Mr. Stanfield’s remarks were very persuasive. In assessing why none of the regional spokesmen fully endorsed the idea of bilateral free trade, the Committee found that political implications and the possible erosion of Canadian sovereignty played a large part. Mr. Grossman’s concerns have already been mentioned and Mr. Planche of Alberta and Mr. Thornhill of Nova Scotia were also clearly uneasy on this score. On the political effect, Mr. Stanfield had some wise words to say and the question is dealt with as a separate issue in Part VI of this report.

2. Economic prospects

As for the economic impact on the various regions, Professor Ronald Wonnacott told the Committee that Manitoba and Saskatchewan would be obvious beneficiaries because, as consumers, they would gain by lower prices and few industries would be at risk. The same, he said, is true of British Columbia and Alberta. “Indeed”, he stated, “Alberta with its petrochemical industry might get the greatest benefits in this group.” The Alberta Minister of Economic Development, the Hon. Hugh Planche endorsed the idea of the sectoral free trade arrangement in petrochemicals and, with the possibility of future Alberta-based manufacturers in other sectors in mind, he expressed particular interest in the potential which markets in Northern California, Oregon, Washington, Idaho and Montana might provide. Both the Hon. Pat McGeer and Professor Wonnacott observed that British Columbia too had the potential advantage of developing various kinds of manufacturing through subcontracting from large U.S. companies across the border.

In respect to Atlantic Canada, Professor Wonnacott predicted that per capita income would increase with the elimination of the tariff. There was also a good possibility of new exports to the rich U.S. east coast markets. There was some chance that new industry could be attracted to this area as

well, but he acknowledged that many of the Atlantic region's present economic problems would likely remain under free trade.

Unexpectedly, the provinces which the Economic Council and Professor Wonnacott expect to do best from bilateral free trade with the United States are Ontario and Quebec, the two provinces which historically have resisted the idea most strongly. At first glance Ontario appears to be quite vulnerable. With 80 percent of its imports coming from the United States, a great deal of Ontario's secondary manufacturing—especially small protected companies and small plants of multinationals—would seem to be at risk initially in a bilateral free trade environment. Major readjustment and reorganization of this sector would be required especially in electrical products, textiles, machinery and metal fabricating industries. Despite these seeming handicaps, however, careful economic analysis indicates that Ontario and Quebec would, in fact, register the largest gains of any region of the country. According to Professor Wonnacott who has undertaken such an analysis:

“... if you are talking about bilateral free trade... then the big advantages of getting access to the U.S. market go to Ontario and Quebec, because they are the ones who are sitting closest to the middle of that big market. So the obvious benefits go to the West, but probably even larger benefits would go to Ontario and Quebec which have been viewed as being the provinces that might lose.” (18:26)

Professor Wonnacott's studies have led him to estimate that Ontario's gains in per capita income could be 10 percent or more.

With the removal of tariffs and troublesome non-tariff barriers, the restructuring of Ontario industry, which is already underway to some extent, could accelerate significantly. The greater specialization and efficiency of the restructured industries would lead to increased export orientation. Even though there has been a gradual shift in U.S. economic activity to the South and the West*, the main centre of U.S. industry and income is still in the northeastern quadrant of the United States. Ontario and Quebec are in an excellent position to service this market. Professor Wonnacott has observed that while the geographic position of these two provinces could be said to have deteriorated slightly from a decade ago, the shift would merely mean the difference for Ontario between a 400 percent expansion of its market instead of a 500 percent.** In fact, Ontario and Quebec would face lower transportation costs to the main U.S. markets than many U.S. points including the midwest or the Pacific northwest.

The Committee noted that, like Ontario, Quebec's principal international market is the United States. Quebec has a strong export base in primary resources, both raw materials (such as iron, copper and asbestos) and proc-

* As discussed and illustrated in the Committee's Vol. II report.

** Wonnacott P. and Wonnacott R. J., "Free Trade Between the United States and Canada: Fifteen Years Later", March 1980, p. 19.

essed products (such as non-ferrous metals, newsprint, pulp and paper, veneers, chemicals, etc.). Strong Quebec-based resource companies could be expected to welcome the idea of bilateral free trade and expanded opportunities for further processing of resource exports would be likely to occur. Certain end product industries such as the transportation equipment industry would clearly benefit from easier access to the U.S. market. Some large rationalized Quebec textile producers would have possibilities of expanding into a duty-free U.S. market while being still protected from low-cost third country competition.

Professor Wonnacott has estimated that the gains from bilateral free trade could be larger for Quebec than for any other Canadian region except Ontario. Moreover, in a bilateral free trade arrangement, certain Quebec industries such as clothing, food and beverages, tobacco, leather and fixtures—industries which are currently well protected by tariffs—might not require as widespread restructuring or rationalization as would many Ontario-based manufacturing industries involving more advanced technology. Many of these Quebec industries would be much harder hit if Canada decided to go to multilateral free trade. The reason for this distinction is that many of Ontario's industries would need to compete unprotected against aggressive high technology U.S. products whereas many Quebec industries would find that U.S. competitors in their product lines, which are similarly protected from cheap off-shore imports by U.S. tariffs, do not represent a threat. Quebec producers of these items would therefore have an opportunity to increase sales in the nearby larger U.S. market, while remaining protected from third country competition there, as well as in the domestic Canadian market. In a North American free trade arrangement it is argued, Quebec's clothing, food and beverage industries would have the potential to expand. On the other hand, it should be kept in mind that Quebec has an unusually high dependency on the markets of other regions of Canada, especially in Ontario, for the sale of many of its manufactured goods. If the Canadian tariff were reduced, Quebec could suffer from competition in Canadian markets from nearby U.S. producers. The competitiveness of Quebec manufactured goods would, in the end, depend on the level of its unit labour costs which, in turn, would depend on higher productivity levels and comparative wage rates. In any case, in view of Quebec's enormous dependence on the North American market, a Canada-U.S. free trade arrangement would clearly be in Quebec's best interest.

Residents in both Ontario and Quebec, like those in other provinces, would enjoy the gain in real income due to lower prices associated with the removal of the Canadian tariff. They would also benefit, according to Professor Wonnacott, from the elimination of the U.S. tariff—both because of the recapture of the duty revenue on current exports of their local industries and

because of the new exports produced by more efficient, rationalized and specialized industries.

Overall, the evidence points to economic gains for all regions in Canada from bilateral free trade, with the biggest dislocation affecting and, at the same time, the biggest gains accruing to the two central provinces. The rationalization of the manufacturing sector in the two central provinces under bilateral free trade would reduce that sector's drain on Canada's balance of payments, a development which would be of benefit to the whole country.

PART IV

Areas of Special Concern

1. Competitiveness

A major trading nation like Canada cannot fail to be concerned about its international competitiveness. Canada's record is, in fact, spotty: strong in freely traded resource products, in processing and in a few manufacturing sectors, but relatively weak in most areas of secondary manufacturing. In its 1978 report, the Committee expressed its concern both over the persistent low level of competitiveness in Canadian manufacturing (with notable exceptions) and the rapidly growing deficit in trade in end products.

This contrast between high productivity in the resource and processing sectors and low productivity in many areas of manufacturing is to some degree self-reinforcing. During periods of strong demand for natural resources, such as occurred during the 1970s, Canada faces a form of the 'British disease.' Mr. Fred Bergsten, a former Assistant Secretary of the U.S. Treasury, pointed to a Canadian policy dilemma similar to, though less severe than, that which Britain and Mexico now face as a result of their oil and gas revenues. For Canada, the strong resource sector has given an upward momentum to the exchange rate, resulting in a non-competitive price structure for the manufacturing sector, which in turn generates pressure for additional protection. Rather fortuitously in 1981, significant outward capital flows, due in large part to increased Canadian investment abroad, exerted an opposite pressure, leading to a decline in the Canadian exchange rate

which was further exacerbated by the purchases of energy companies under the Canadianization program. This lower dollar, to some degree, shielded the manufacturing sector.

By most of the traditional criteria for measuring Canada's relative competitiveness vis-à-vis the United States, i.e. comparative wage ratio, productivity rates, unit labour costs, work stoppages etc., the situation has remained static or has even deteriorated somewhat since the slight improvement manifested in 1978. (For a more detailed look at Canada's competitiveness see Appendix C.) Dr. James Frank of the Conference Board in Canada warned the Committee that the decline since 1975 in the number of Canadian industries at or above parity with comparable U.S. industries was not a reversal of a long-run trend leading to wage parity across the board. The apparent improvement merely reflected the continuing devaluation of the Canadian dollar over these years.

Statistics in 1979 and 1980 indicate that, after the one-year reversal in 1978, wage settlements in Canada are rising at a slightly higher rate than they are in the United States. Canada's record in work stoppages is also inferior; in only two years since 1970 have industrial disputes in Canada not led to more days lost per thousand employees than has occurred in the United States. Although there has been a modest narrowing of the gap in rates of productivity over the past decade, the improvement has been insufficient to compensate for the increases in comparative wage rates. As a result, unit labour costs are once again increasing faster in Canada than they are in the United States.

The relative decline in Canadian competitiveness during the last decade has been compensated for and, to some degree, masked by the devaluation of the Canadian dollar. On an exchange rate adjusted basis, Canadian wage rates now stand at approximately 95 percent of those in the United States. But had the devaluation of the Canadian dollar not occurred, Canadian wages would be at considerably higher levels than those of the United States.

The Committee believes a decision to move to bilateral free trade could provide the shock necessary to increase competitiveness. As this report has shown, a growing number of witnesses from the private sector have recognized that bilateral free trade could offer manufacturing industries opportunities to specialize and achieve economies of scale, which could be translated into higher rates of productivity. Canada has a trained and effective work force capable of doing better if given the opportunity. According to testimony given by Mr. J. D. Frank, of the Conference Board in Canada, the only sectors where the levels of Canadian productivity have been able to equal or surpass those in the United States are precisely those which have free or almost free access to the U.S. market, namely wood products, metal products, motor vehicles and parts. (See table 5, Appendix C, page 139).

While the resource sectors have certain natural advantages, the Committee is persuaded that a key factor determining the level of productivity in many areas of manufacturing appears to be the size of the market.

Witnesses who claim to accept the need to move to free trade are nevertheless divided on how best to proceed. Some argue that the competitiveness of Canadian industry must first be improved before it faces free trade; otherwise they fear it would lose ground to stronger American competition. Their emphasis on the time needed by industry to adjust leaves the impression that they would not be ready for free trade until Canada's competitiveness has been re-established. Others, perhaps more genuinely persuaded of the benefits to be gained, maintain that only the shock of a commitment to move to bilateral free trade and a firm timetable can force on industry as a whole the restructuring necessary to achieve higher productivity.

The Committee considers the debate to be in some degree spurious. If the government were to set the goal of achieving free trade with the United States, and the U.S. Administration were to respond with a show of interest, companies would immediately begin to calculate the impact and adjust to the potential new market situation. As the CMA pointed out to the Committee, most businesses would try to adapt as quickly as possible to a free trade environment if they thought it was coming. However, moving toward bilateral free trade would not be an instantaneous or abrupt change-over, since it would take time to negotiate a free trade arrangement and any agreement would provide a reasonable transition period to permit firms to adjust. (See page 90).

The Committee recognizes the need for Canadian industry to become more competitive and is persuaded that this objective is more likely to be achieved if a clear decision is taken to seek free trade with the United States.

2. The technology race

Free access to the larger North American market would open up broad avenues of opportunity for Canadian technological and innovative capabilities. It could do much to stimulate increased research and development in Canada. But it would also present major challenges. United States companies are extremely competitive in high technology fields, usually world leaders. If Canada is to 'place' in the world technology race, government and industry must improve their performance in the risky and expensive business of expanding Canadian innovative capacity and implementing it commercially.

In relative terms, the United States spends much more on R&D than does Canada, 2.5 percent of GNP as compared to about 1 percent. The lower Canadian level is both in government support and private sector spending.

The problem of Canada's dismally low level of R&D spending has gradually been recognized by the government over the past decade. But despite incentives in the form of tax write-offs, investment tax credits and a variety of grants programs, the government has been unable to turn the situation around. At best, Canada could be said to have arrested the dramatic decline of R&D spending of the early 1970s and to be holding its own. Hardly good enough.

In January 1981 the government reiterated its aim of raising Canada's R&D expenditures to the equivalent of 1.5 percent of GNP by 1985.* To meet this new objective, federal spending will have to rise from \$973 million in 1979 to \$2.52 billion by 1985, while industry's spending will need to rise even faster, from \$875 million to \$3.78 billion. According to OECD statistics, R&D spending by Canadian industry is significantly below that of industry in Canada's major competitors. Reflecting this fact in its program, the government intends to increase its R&D expenditures by 17 percent per annum over five years, but has said it expects industry's spending to rise by 27 percent.

During the hearings, the Committee probed business witnesses as to the relative usefulness of the two principal approaches to stimulating R&D in Canada—tax incentives and grants programs. As in the earlier hearings, there was general support for tax incentives from large and established companies such as Canadian General Electric and Alcan, two of the largest R&D spenders in Canada. But it was also evident that tax incentives failed to help small, medium-sized or new companies which, lacking profits, do not qualify for tax benefits. Moreover, there was criticism of the incremental aspect of the R&D incentive.**

Mr. C.D. Reekie of CAE Industries Ltd. explained:

"... it is not at all clear that unless you keep on spending more than you have spent you will get any advantage. You have to continue on with increments each year in R&D spending or you do not get the benefit. So then, at some point, you are just not going to keep on spending." (15:44)

As for the grant programs, high technology firms in defence-related fields bestowed high praise on the government's Defence Industry Productivity (DIP) program. The support was essential, it was reiterated, to compete internationally in advanced aerospace products. Mr. E.L. Smith, president of Pratt and Whitney, attributed his firm's success "very directly to the financial support we have received from the federal program under the DIP program." Mr. John Sandford, president of de Havilland, called the DIP pro-

* The same objective was announced first in 1979 to be realized by 1983.

** In addition to the 100 percent write-off for current and capital expenditures on R&D, firms may qualify for a supplemental 50 percent deduction for incremental R&D (defined as R&D expenditures in excess of the previous three-year moving average).

gram "a very vital and effective program... Every \$1 invested... is estimated to yield \$28.3 in sales." Mr. John Simons, vice-president of Canadian Marconi, said that without a doubt the DIP program has been "the most successful government economic development program" and called it "the essential link in the continued export success of Canadian firms." He was critical, however, that the level of DIP funding had not kept pace with inflation and that, for a time, the program had been discontinued, a fact which had cost Canadian industry many new opportunities and a loss of momentum.

The other grant program in support of innovative manufacturing is the Enterprise Development Program (EDP). Replacing seven earlier programs, it is focussed on helping medium to small manufacturing and processing companies to generate industrial innovation and adapt operational methods. Among business witnesses there was support for the EDP program, but it was tempered by their criticism of the tight administrative control and review procedures, which left decisions to be made by bureaucrats as to how the funds should be spent. Business was better able to do this itself, private sector witnesses maintained. Other critics have pointed to the difficulties officials naturally have in assessing which ideas and which firms to give the grants to.

The Committee concludes that grants and tax incentives are both necessary in assisting companies in Canada to undertake R&D. In defence-related fields, the DIP grants are clearly necessary to compete with the rich funding of the research efforts by defence departments of competitors in other countries. However, the Committee heard some critical comments from Mr. David Mundy with regard to the levels of R&D undertaken by Canadian firms in the defence production field. He maintained that Canada had been "chiselling" its way into U.S. programs under the defence production sharing arrangement, trying to get contracts awarded to Canadian firms without paying the R&D costs. Canada had been operating on a shoestring and it was not working, he said. He suggested that the way to get better access to this all-important technology was for Canada to offer to make a long-term funding commitment to a major U.S. project—as it did with the space arm—on the condition that Canadian industry could participate in the technological mainstream of the program.

A related point by Mr. Simons concerned the disadvantages of offset procurement arrangements made as part of defence equipment purchases. He maintained that Canadian companies learn little from producing from established designs and the Canadian taxpayer suffers by paying the cost premiums associated with small production runs in a second location. To increase Canada's technological capability, he urged that the premiums be invested in R&D of *new* products and their purchase by the U.S. Defense Department negotiated as offset. A small move in this direction was made with a 6 per-

cent requirement for advanced technology offset opportunities as part of the fighter aircraft offset program. While there was evidently some difficulty initially in filling this 6 percent, the Committee agrees that such a thrust makes sense. Short-term employment objectives should not obscure the longer lasting benefits from new product technology.

The Committee went into the question of why the Canadian R&D performance in the manufacturing sector has been so dismal. Many in Canada blame the high levels of foreign ownership and assume that the remedy lies in 'Canadianization'. This is, of course, an oversimplification. But it is true that while certain foreign-owned firms do some of the highest levels of R&D in Canada, many subsidiaries, particularly of the branch plant 'miniature replica' variety do very little. They have no incentive to do so.

The Committee has concluded that there is an essential ingredient which such firms look for before they commit money to R&D. Market size is the critical factor. In every instance which the Committee examined of private firms which engage in significant R&D expenditures, they had access to a market larger than that which Canada alone offers, whether it was through a duty-free trade arrangement, as for aerospace and defence production, or as the subsidiary of a large U.S. company, through an established U.S. source of technological and engineering advice and marketing support. The point was put succinctly by Mr. Simons, whose high technology company, Canadian Marconi, spent \$10 million on R&D in 1980. He told the Committee:

"It is almost self-evident from the level of R&D funding required that the Canadian domestic market is too small to support anything developed solely for Canadian use. Thus access to a larger market is a necessary condition before R&D investment can pay off." (12:39)

This situation, in the Committee's opinion, accounts for the high levels of R&D undertaken by a number of multinational companies in Canada. Some critics argue from the experience of the auto industry under the auto pact that, with free trade, all R&D would be moved abroad and Canada would become a technological parasite. This analysis is valid for the traditional branch plant which is making carbon copies of the parent's production. The auto industry fits this model. Production lines are readily interchangeable from Windsor to Wichita and all draw on a single pool of R&D.

By contrast, subsidiaries which undertake extensive R&D in Canada such as CGE, Canadian Marconi, Pratt & Whitney, Litton Systems or Garrett Manufacturing, are usually specializing in a limited range of products for the North American or world markets. They need their own R&D and naturally are quick to take advantage of the support available from the Canadian government. U.S. subsidiaries of Canadian multinationals, such as Moore Corporation and Northern Telecom, have themselves done the same thing in reverse in the United States.

Market access is important because the total cost of developing and successfully marketing a new product is enormous. Research costs are only the first step in a long and costly process, which includes engineering, start-up manufacturing and market development phases. The way a businessman looks at the problem was graphically expressed by Mr. M. J. McDonough, vice-president of the parent Westinghouse company.

"If one looks at a new business based on designing and building a product, the front end R&D is less than 10 percent of the cost of embarking on and fulfilling a project. One could do all the R&D in the world . . . and have only done 10 percent of what is needed . . . and that is not the tough part. The tough part is the 90 percent. So when one embarks on an R&D program, one had better think about how that R&D is going to be implemented. To subsidize and stimulate R&D alone, without looking at the mechanism required to employ that R&D, would be a waste of money." (16:35)

This comment by Mr. McDonough, whose Canadian subsidiary has a good record of R&D undertaken in Canada, may be one of the explanations as to why so many companies in Canada do not take advantage of the R&D support which the government offers. They lack a large enough market to cover the full cost of developing, launching and selling a new product; and the profit to be gained from the Canadian market, even if they are successful, usually does not justify the risk inherent in high development costs for a new product. It is not that Canadians are less innovative, or even that they are afraid to take risks, as is so often alleged. An important explanation is the restricted market which ensures that the spectacular successes of a Polaroid or a Xerox can never be duplicated in Canada and makes even the recovery of development costs a dangerous gamble.

Canadians have, indeed, been successful innovators, but too often their ideas have had to be executed abroad in larger markets. Sadly, this has brought little benefit to Canada. The example cited earlier by the Hon. Patrick McGeer is again relevant here. The B.C. Minister referred to a Canadian pharmaceutical company which decided that, in order to exploit its discovery, it had to establish a production facility in the United States. It was so successful that the American part of the company became predominant and eventually the company was sold to a large U.S. corporation. Had there been no tariff or non-tariff barriers to block the company's exports from Canada, no doubt this company would still be producing in Canada.

Conversely, Canada has benefitted from imported technology developed by others. It has been suggested that, in order to stimulate R&D expenditure in Canada, imported technology should be screened by FIRA or imported by independent Canadian firms via arm's length licensing agreements. The Committee completely disagrees. Canada has profitted substantially from R&D imported through subsidiaries, subsequently adapted by them and exported. Canadian firms frequently find it easier and cheaper to buy technology and modify it than to develop it in Canada. The outstanding success

of the Japanese in adapting imported research findings gives convincing support to this procedure. Canadian industry must hone its ability to adopt and adapt innovative technology as well as develop it. It should be ready to import knowledge in order to create new technology.

Efforts by the government, as now provided under the EDP, to get around this problem by offering grants to support later phases in product development, carry their own risk. One such action which attracted considerable public attention involved a grant* to Honeywell Limited of Toronto to develop a liquid level sensing system. In 1978, the U.S. Treasury responded to a complaint from an American competitor by imposing a countervail duty, on the grounds that part of the grant to Honeywell was not to support R&D, but to subsidize the successful marketing of the product in the United States. This was a problem that officials of the Department of Industry, Trade and Commerce were reluctant to talk about before the Committee. They left the impression that it was a grey area which they thought it wise to leave in obscurity; publicity would only attract undesirable U.S. attention. Even so, the Honeywell experience frightens other companies from going the same route.

This report has stressed the theme that the Canadian market is often too small to justify the development of many specialized products; if a manufacturer cannot anticipate sales in the United States or abroad, he will not proceed. In the United States, government assistance is justified to develop products for the huge domestic market. In Canada, a company with an idea for a product which could not generate sufficient sales in the small home market to cover development costs either admits that it is aiming at the foreign market, in which case, some government support may attract countervail, (i.e. Honeywell) or it dissimulates. As has been noted earlier, this is a problem which would have to be dealt with in the free trade negotiations. It would be necessary as part of the agreement to reach an understanding as to which development costs the two governments would mutually accept and which would be unacceptable. The aim should be to reduce to the minimum the uncertainty faced by the private sector.

In conclusion, the Committee is concerned above all that Canadian industry be able to compete in the technology race of the 1980s and 1990s. The essential and to date neglected factor needed to stimulate increased R&D is a free trade agreement with the United States, thereby securing for Canadian entrepreneurs access to a market large enough to support the full range of development costs involved in getting new products to market. Indigenous R&D should continue to be encouraged by a mixed system of tax

* Under the Program for the Advancement of Industrial Technology (PAIT), a program which was subsequently melded into the EDP.

incentives and grants. But expensive R&D should not be pursued as a goal in itself, particularly when it might be cheaper to import technology and adapt it.

And, as part of a bilateral free trade agreement, an understanding should be sought as to which forms of development support would be mutually acceptable, in order to reduce uncertainty and limit the already high risks faced by the private sector in product innovation.

3. Canadian non-tariff measures

This report has emphasized throughout that one of the major benefits for Canada of a bilateral free trade agreement would be the possibility of getting a handle on U.S. non-tariff barriers—the trade obstacles which are almost certainly going to loom increasingly large for Canadian exporters. But a bilateral free trade agreement is a two-way street. What about Canadian non-tariff barriers?

The United States is not unaware of Canada's non-tariff barriers. Nor are U.S. industries. For example, a recent study for the American Iron and Steel Institute examined, at both the federal and provincial level, how Canadian procurement laws and practices discriminate against foreign materials and suppliers. It set out in considerable detail its case that, although largely unlegislated and out of public view, Canadian procurement favoured domestic procurement through unpublished administrative policy and informal practice. Canada's import displacement programs, including its monitoring of the purchasing activities of private companies involved in energy megaprojects, its expanding aid to the 'picking winners' program, or the proposed import policy involving a 'basic price system', all fall within the definition of non-tariff barriers. So do provincial monopolies over wines and spirits.

In respect to Canadian procurement, Canada is in a weak bargaining position to negotiate against U.S. procurement policies, given the current state of federal-provincial relations. While preferences exist in the United States in at least 37 states, in Canada, protective provincial preferences result in the fragmentation of Canadian production facilities which itself decreases Canadian cost competitiveness in foreign markets. In this regard the Committee views with approval the recent efforts of the federal government and the Ontario government to co-ordinate and strengthen the Canadian procurement market.

That said, however, the Committee disagrees with the policy approach urged by economic nationalists when confronting U.S. non-tariff barriers, namely to increase Canada's industrial strategy measures designed to protect the domestic base and to formulate and legislate new Canadian non-tariff barriers paralleling those in the United States.

The Committee asks where such a policy would lead. As has been stated earlier in the report, the Committee completely rejects the argument that such a protective strategy will render the Canadian manufacturing sector internationally competitive. On the contrary the Committee is convinced that this goal can best be achieved through free trade; it is also convinced that the surest and perhaps only way for gaining exemption from, or achieving some control over, punitive U.S. non-tariff barriers is through a bilateral free trade agreement.

Nonetheless, it is only realistic to recognize that in bilateral free trade, Canada will have to 'give' if it wants to 'get'. For instance, in order to open U.S. procurement doors for their industries, Canadian provinces are going to have to open their own procurement. But not all non-tariff barriers need be of concern in a free trade agreement—only those established for purely protectionist purposes. Those which are essential in controlling the circumvention of accepted trade practices, such as anti-dumping procedures etc., could be expected to be retained, as would those such as product and safety standards which had incidental non-tariff side effects.

Finally, because the Canadian federal government has limited jurisdiction constitutionally in many areas where provincial policies have been particularly active in recent years, the government would undoubtedly need to have obtained some sort of agreement on overall policies and also a negotiating mandate from the provinces prior to undertaking a bilateral agreement.

4. FIRA and the control of foreign investment

The extent of foreign and particularly U.S. ownership and control of Canadian industry has been a controversial issue in Canada for two decades. The role of FIRA (the Foreign Investment Review Agency), the agency created to monitor and pass on new investment proposals by foreign interests, has been a subject of particular concern to the business community in the United States and elsewhere. The coincidence of the declaration in the speech from the Throne of 4 April 1980 that the government intended to strengthen and extend FIRA's powers with the Canadianization features of the National Energy Policy announced in the October, 1980 budget have alarmed United States authorities and aggravated relations between the two countries.

Not surprisingly, in this environment, many witnesses appearing before the Committee in Canada and the United States assumed that a condition of U.S. participation in a free trade agreement would be some check on FIRA's powers and possibly even its termination. Only one American witness questioned this view, claiming in a colourful analogy that FIRA was of no more concern than a California zoning law.

The Committee appreciates that FIRA is too important to be ignored in negotiations on bilateral free trade. The question of FIRA must be faced, but it does not follow that the United States would insist on its being closed down. Sweden had foreign investment controls when EFTA was formed, and it was permitted to retain them. This is an important precedent. During the transition period which would lead to free trade, Canada could claim the need for regulations to ease that process. A good case could be made that, without some sort of screening process during the transition period particularly, small dislocated Canadian firms previously dependent on the Canadian domestic market and faced with the need to restructure would be "easy picking" for the stronger foreign corporations with both the necessary financing and established markets available. It would seem reasonable to include foreign investment controls in the agreement for the transition period. Once the transition phase had been concluded, Canadian industry should be sufficiently rationalized to be competitive and FIRA's review processes should be less necessary.

Even in the absence of free trade negotiations, Canada cannot ignore U.S. concerns about FIRA's powers as the current situation reveals. Washington reacted strongly against the announcement in the 1980 Speech from the Throne that FIRA would be strengthened. Nor has this negative perception been fully assuaged by the policy change announced by the Finance Minister, the Hon. Allan MacEachen in the November 1981 budget that no amendments would be made to the Foreign Investment Review Act for the time being.

5. The exchange rate

The Committee reached the conclusion in its 1978 report that, should Canada and the United States enter into a full bilateral free trade arrangement, "the exchange rate would become the principal equilibrating mechanism". (p.114) As this was an important point, the Committee devoted some time during its current hearings to examining the implications of bilateral free trade for the exchange rate.

While the exchange rate reflects in part competitive differences between the two countries, expressed in terms of wages, productivity and so on, it also reflects a host of other factors—capital flows, dividend payments, monetary policy, etc. In very broad terms, the exchange rate is indeed an important adjusting mechanism. But the picture is extremely complex and testimony was divided as to how bilateral free trade would influence the exchange rate.

The extent of the initial effect on the exchange rate, witnesses claimed, would depend to some degree on the scope of the free trade agreement, and ultimately on the resulting balance of trade. In the short run, the Canadian dollar could be expected to weaken, owing to the greater structural adjust-

ment costs, to be borne in Canada. Over the long run, however, the Canadian dollar would probably strengthen as Canadian manufacturers begin to switch to longer production runs and reap the benefits of greater economies of scale. Of course, this outcome would depend heavily upon the relative levels of productivity, wage rate differentials and comparative inflation rates between the two economies.

Professor Robert Dunn Jr., of George Washington University told the Committee that he expected the financial impact of a bilateral free trade agreement on the exchange rate and on cross-border capital flows would be marginal. His conclusion was based on the premise that any bilateral free trade agreement would be negotiated so as to yield a rough balance of advantage to both sides. Professor Dunn supported the continued use of a flexible exchange rate policy under a free trade regime, especially during the transition period. He argued that attempts to gain competitive advantages by either government by pegging the exchange rate artificially low would undoubtedly cause problems, especially in terms of the Canadian reserve requirements to undertake foreign exchange market intervention. Mr. Lawrence Krause of the Brookings Institute added that, if the exchange rate were left largely free to do the adjusting, gross distortions could be avoided or minimized.

Dr. David Dodge, a Canadian economist, approached this problem from a different perspective and reached a contrary conclusion. He assumed that Canada would be "driven to think very hard about pegging the exchange rate" between the two countries, to overcome U.S. concerns that the Canadian authorities could use "monetary policy . . . to depreciate our currency and hence gain a competitive edge on American firms".

The Committee cannot anticipate how the U.S. government would respond on this point if negotiations on bilateral free trade were to commence. The European Community, with a much more integrated structure than that being proposed for Canada and the United States, has learned from painful experience that a degree of exchange rate flexibility between members is necessary. The Committee is of the view that a flexible exchange rate could cause the least difficulty, and it takes comfort from the fact that U.S. witnesses on this point thought a flexible exchange rate would be preferred by the U.S. authorities. Accordingly, the Committee concludes that the flexible exchange rate policy could and should be maintained under a free trade arrangement.

Increased bilateral trade flows resulting from a free trade arrangement would generate some increase in cross-border capital flows, reinforcing the already close integration of Canadian and U.S. capital markets. The result might be a greater speed of equalization between the interest rates charged in both national capital markets, although these markets are so highly inte-

grated already that the Committee doubts whether such a change would be significant.

As a medium-sized trade-dependent economy bordering upon the large metropole of the United States, the Committee recognizes that Canadian monetary and exchange rate policy choices have been and will continue to be, to a large degree, responsive to the policies adopted in the United States. The floating exchange rate has helped to some extent to insulate the Canadian domestic policy milieu from such external pressures. Nevertheless, during 1981, for example, the 'tight' U.S. monetary policy has forced Canada to accept a higher level of domestic interest rates than would appear to be warranted by purely domestic economic factors. With differing policy approaches towards the control of inflation in Canada and the United States, it is likely that problems in this area will continue to cause concern for Canadian central bankers. However, the Committee received no evidence that such problems would be aggravated under free trade between the two countries.

6. Tax harmonization

The Committee received conflicting testimony with regard to the degree of tax harmonization necessary under bilateral free trade. Dr. David Dodge said he thought "it is inevitable that, as we move towards freer trade in the sense of the removal of tariffs and non-tariff barriers, we would be forced towards a standardization of tax and subsidy arrangements". Later he acknowledged that "further integration did not take place in, for instance, the European Free Trade Association", but he speculated that "circumstances are unique in each case, and the unequal nature of partners in the Canada-U.S. free trade area probably means that Canada would have to adapt its micro-economic policies to those of the U.S."

Professor Weintraub, an American witness, adopted a rather different stance, looking on tax harmonization not as a necessary condition for a free trade arrangement, but rather as a potential and perhaps desirable outcome. He said:

"...that tax structures and fiscal policies could remain as they are, and the differences (between Canada and the U.S.), as they affect trade, would come out in the exchange rates. Just how serious the difficulties would be, I do not know. Having said that, I suppose that if you wanted to take this one step further and make the whole system somewhat more efficient, you could seek to harmonize taxes, particularly with regard to indirect taxes, but I do not think it is required."(17:30)

The Committee did not examine the tax changes which might be contemplated in order to enhance possible gains from trade and specialization of production. A cursory inquiry indicated that there was sufficient similarity between the two tax structures to offer favourable prospects for tax harmoni-

zation if the government wished to proceed along this route. Furthermore, the Committee concluded that tax rationalization was a goal which could be pursued subsequent to agreement on a free trade arrangement and on an *ad hoc* basis.

Whether or not Canada moves to free trade, the government has no alternative to responding to changes in U.S. policy. The Committee did agree whole-heartedly with the assertion of the Hon. Larry Grossman, that "on a longer term basis Canada will have to ensure that its own treatment of investment income and regulatory policies remains competitive". The Committee further concluded that there is no requirement under free trade that Canada harmonize its tax policies with those of the United States.

PART V

Conditions of the Agreement

It is not practical at this stage to make detailed proposals as to what a free trade agreement with the United States should contain. A comprehensive examination of the affected industries, their tariff levels and the necessary adjustments would need to be made first by officials on both sides. Extensive negotiating would be required on the definition and ways of restricting certain non-tariff barriers. The Committee is limiting itself at this point to some general observations on the terms of such an agreement.

1. Timing and scope

In moving to a bilateral free trade agreement by means of the Committee's recommended 'interim agreement' procedure, the two countries would only be required to file with the GATT their plan and schedule for eliminating "substantially all" tariffs within a "reasonable" length of time. There is no established GATT precedent as to what the transition period should be. In order to protect its industries as much as possible and help them adapt to a less protected position Canada could, if it wished, negotiate a long adjustment period.

Academic witnesses have suggested transition periods ranging from 5 to 15 years. In proposing the longer period, Professor Weintraub argued that just as the Tokyo Round tariff reductions are undertaken gradually over eight years to avoid sudden jolts, so the remaining bilateral tariffs could be

gradually phased out over 10 to 15 years. Further, it would be prudent to request the longer rather than a shorter period and, if the process could be speeded up, so much the better.

On the other hand, Mr. Thibault of the Canadian Manufacturers Association, argued that the impact would probably occur much more rapidly than anticipated. Once a firm policy decision to go to bilateral free trade became known, Canadian companies would be unlikely "to sit around ten years waiting to make a fundamental decision. The production would be allocated . . . it would be a relatively short period of time in which . . . all the essential decisions would, in fact, occur." Major adjustment decisions could take place in as short a period as two years, he said.

The Committee considers that Canada should try to negotiate a period of 8 to 10 years as the transition stage to the achievement of a free trade area. It could begin in 1987 when the Tokyo Round cuts would be all in place. However, in requesting this medium to long transition period to protect weaker companies, the Canadian government should be aware that it could frustrate the relatively stronger companies or industries which would be able to adjust more easily. Pressure could come from these stronger industries to speed up the process and give them full tariff-free access quickly. If the accelerated dismantling of tariffs in EFTA and in the European Community—tariffs which were higher and more disparate than Canada-U.S. tariffs—is any example, the time frame could be considerably compressed. But these European adjustments took place in the 1960s—a period of dynamic growth unlikely to be paralleled in the foreseeable future—and it seems safer to provide for the longer period in the 1980s and 1990s.

What about a faster elimination of U.S. tariffs than Canadian? Could the United States be persuaded to phase out its tariffs in half the time, for example? Academic witnesses, including Professor Wonnacott, considered that it would be possible. If both sets of tariffs were cut by the same absolute amount, he pointed out, the U.S. tariff would be eliminated sooner since U.S. barriers were smaller to begin with. On the grounds that affected Canadian industry will be faced with a major reorganization—which is not the case for U.S. industry—**Canada should press for a faster elimination of U.S. tariffs than Canadian tariffs as part of the agreement.**

Traditionally, Canadians and Americans have generally preferred a fairly informal approach to their bilateral commercial arrangements, with general principles stated and much of the interpretation and adjustment left to be settled through normal established channels. It is true that such an approach permits more flexibility in coping with unexpected developments than rigidly specified rules and procedures. The Stockholm Convention establishing EFTA lacked detailed rules and definitions in several areas and this fact has since been considered to have promoted an effective and flexible

approach to problem-solving. The rules were interpreted and regulated by *ad hoc* committees of representatives of the member states reviewing the issues and reaching negotiated settlement. EFTA's pragmatic handling of non-tariff barrier problems in this fashion has been termed "pioneering" and "innovative" and as having made a significant contribution to international trade practices.

On the other hand, because the auto pact was not explicit on whether the safeguards were transitional or permanent, Canada and the United States have had serious bilateral disputes which both governments would rather avoid. Industry too would likely prefer succinct guidelines. Professor Peyton Lyon of Carleton University argued that as the nation that had most to gain from free trade and most to lose if the other participant were to change its stand, Canada had a strong interest in a precise detailed agreement.

"The more precise and permanent the treaty and the more effective a regulatory mechanism, the more confidence industry would have in that arrangement; and only if entrepreneurs had confidence in the agreement's permanence and effectiveness would industry be likely to make the necessary adjustments and long-term plans that would maximize the economic benefits of the expected free trade." (2:11)

The Committee completely agrees with this approach. **Free trade would be of such major importance to Canada that every attempt should be made to anticipate potential problems and spell out as fully and precisely as possible the scope and terms of the agreement.** Businessmen must be sure that the rules are there and that they will stick.

2. Rules of origin

In contrast to the common external tariff characteristic of a customs union, **a free trade area between Canada and the United States would retain differences in tariff levels and in tariff policies with third parties.** The GATT definition of a free trade area requires only that the duties be eliminated between the two countries on products originating in each country. **For all other trade the two countries could maintain their separate tariff rates and/or quotas.** This raises the problem of 'trade deflection', which may occur when goods from third countries enter the free trade area via the country with a lower tariff on that particular product. If the product were then re-exported to the other member of the free trade area at zero tariff rate, it would provide an unfair benefit to the country with the lower external tariff. When further processing of resource products or manufactured goods with imported components are considered, the distorting impact quickly becomes significant. For this reason, any free trade area must establish 'rules of origin' for intra-member trade and, in fact, such rules of origin have been established in all preferential trade arrangements. Although there are no specific

provisions laid down by GATT concerning rules of origin, certain precedents exist, the most relevant being those adopted by the EFTA.

It is important to note that if strict rules of origin are applied, the larger country will have a greater capacity to source requirements internally. Thus, if the U.S. exempted from duty the U.S.-made components in goods imported from Canada, but imposed strict requirements on externally sourced inputs, then Canada would be forced into increased sourcing from the U.S. market for semi-processed and raw material inputs. If such U.S. sources were not the least-cost suppliers of such inputs, the trade diversion effects would become disadvantageous for Canadian exporters, particularly so in respect to those products which are not only exported to the U.S. market, but to overseas markets as well. Manufacturers would resist the costs involved in maintaining two inventories of materials, one qualifying for exemptions and the other for materials which did not qualify. Canadian exporters in such a situation could find that they had priced themselves out of third country export markets.

An origin system may be liberal or strict. A liberal system allows a substantial proportion of 'free trade area' products to originate in non-member countries and it is likely to result in the least trade diversion effects in terms of existing patterns of supply of raw materials or semi-processed goods.

The 1965 Canada-U.S. Automotive Agreement imposed a rules-of-origin condition for duty-free access to the U.S. market, aimed specifically at preventing trade deflection by third country automotive producers using Canada as a channel to circumvent the U.S. tariff. Under the pact, imports from Canada must contain a minimum 50 percent North American content, on a value basis, in order to qualify for duty-free treatment in the United States.*

The EFTA adopted a liberal set of origin rules under which a product qualified for duty-free treatment if up to 50 percent of its export price originated in the free trade area. In EFTA, it was initially feared that sizeable deflections of trade to lower-tariff members of EFTA would occur, or that uneconomic structures of production would result, if manufacturers whose products depended heavily on imported inputs shifted their operations and investments to the lower tariff countries. **In actual fact, however, the EFTA rules of origin appeared to work surprisingly smoothly with no visible deflections of trade or production.** One factor considered important in this success-

* Both Canada and the United States also have rules of origin, somewhat differing, associated with their arrangements under the Generalized System of Preferences (GSP) for 'developing country' exports. Under the GSP arrangement, Canada accorded easier access to products originating in a preference-receiving country as long as not more than 40 percent of the value was due to imports from outside the preference-receiving country or from Canada itself. In the U.S. system, at least 35 percent of the value must represent content from the preference-receiving country in order to benefit from the easier access (or 50 percent if there were a designated association of countries treated as one country for purposes of the Generalized System of Preferences).

ful result was the fact that, in EFTA countries, tariff levels on raw materials and semi-processed goods were, with few exceptions, low or non-existent, and that external tariff disparities between the member countries were relatively small. Since the same situation pertains to Canada and the United States, it may optimistically be predicted that a liberal origin system would suffice to restrict trade deflection in a Canada-U.S. free trade area.

The Committee concludes therefore that, while Canada must protect itself from harmful trade deflection, particularly in view of the fact that U.S. tariffs are generally somewhat lower, the rules of origin should be liberal, to give Canadian manufacturers the possibility of continuing to source imports from the least-cost supplier, with the least detrimental effect on Canadian exports going to a duty-free U.S. market.

3. Exceptions and safeguards

Exceptions to free trade agreements and escape or safeguard clauses are normal features in free trade treaties. The most notable exception in a Canada-U.S. agreement would be agriculture. Standard reservations are usually made relating to the protection of health, morals and national security. **Each country would retain full sovereignty over all matters relating to customs administration and to the imposition of their individual tariffs against third countries. In addition, certain escape or safeguard clauses would be in order, permitting member countries faced with disruptions in particular sectors due to tariff cuts to impose quantitative restrictions, providing rigid requirements are met.**

A temporary protective device referred to by Professor Wonnacott—the system of trigger points used in the Swedish-EC trade agreement—is a possible procedure. The idea is to have a temporary restraint available if imports flood in over a brief period during the transition in such quantities as to reach a trigger point. Another device used in the EFTA tariff-eliminating process which could serve as a possible model is the system of ‘déalage’ whereby a country which felt it was suffering considerable strain on a sensitive item due to tariff removal would be allowed to get out of step temporarily and delay a tariff cut—usually only for a few months—until its industry could catch its breath.

It might also be politically necessary to negotiate guarantees for Canadian employment during the interim period, perhaps along the lines of the auto pact safeguards. However, in order to be acceptable to the United States, which has long argued that the auto safeguards had been intended as transitional, it would be essential to set a rigid time limit on such guarantees. They would be short-term transitional safeguards only. In addition to annoying the Americans, the fact that employment in the auto industry in Canada

has been safeguarded with no terminal date has, as Professor Wonnacott pointed out, eliminated a natural moderating influence on the wage rates.

"I believe it is very important to specify [a] time period, so that the labour force and the industry realize that there is a day of reckoning when they have to be world competitive." (18:24)

An escape clause which has been used in other free trade agreements, including the EFTA agreement, relates to the use of quantitative restrictions in the face of a balance of payments emergency. Canada may consider that this would be useful insurance. On the other hand, Canada may prefer to try to negotiate an exemption from a future imposition of a U.S. surcharge, as occurred in 1971. At that time, the United States exempted all goods trading duty-free from its 10 percent surcharge. This automatically exempted exports from Canada's automotive and defence production industries, as well as exports of crude and some processed goods. If such exemption for all tariff-free trade could be negotiated, Canada would be protected from future U.S. actions against other trading partners. But it could not have it both ways. If it obtained this exemption, Canada would have to relinquish the possibility of using quantitative restrictions against U.S. duty free imports when it had a balance of payments problem of its own.

4. Adjustment assistance

Most of the burden of adjustment resulting from a decision by Canada and the United States to move toward bilateral free trade would fall on Canada. The reason for this is quite straightforward: the significance of U.S. competition to Canadian industry is much greater than vice-versa. Hence, a change in the North American competitive environment caused by a move to free trade would be reflected, in a proportional sense, to a much greater degree in Canada than in the United States. While Canadian adjustment costs would, as a result, be proportionally greater than those borne by the United States, it is important to note that Canada stands to gain more from free trade. A well-prepared program of adjustment is therefore directly connected to the realization of Canadian benefits from bilateral free trade.

Representatives of the Canadian Manufacturers Association expressed the view that there is, at present, no well-defined program of adjustment assistance in place in Canada. This could be important if the scenario suggested by Mr. Thibault of the CMA is accurate. As already noted, he anticipated that corporate decision-making would begin to be influenced even before a final agreement on free trade was reached. Such a reaction is to be expected of the more forward-looking Canadian companies, if not the entire business community. The Canadian government would therefore be wise to present an overall adjustment assistance strategy well in advance of the conclusion of a free trade agreement. The date of implementation of the strategy

and the duration of the assistance to be provided should also be made public as soon as possible. Firms anticipating their position in a future free trade environment would then be able to take into account, at an early stage, all the implications of such a strategy relevant to their particular short-term and long-term plans.

The provisions for adjustment assistance contained in the federal government's policy for the clothing and textile sectors are, to a degree, illustrative of those contemplated by the Committee as part of a bilateral free trade agreement. The major adjustment program announced on June 19, 1981 allocated \$250 million over 5 years to establish new employment opportunities in communities affected by textile and clothing industry restructuring and to assist in the modernization of viable firms. The labour adjustment component emphasizes training and other labour development programs and extends measures such as portable wage subsidies to textile and clothing workers moving to alternative occupations. The increase in efficiency required of Canadian producers, as import barriers are reduced, will be facilitated through grants for modernization and funding for equipment purchases or plant layout changes. Low interest loans will also be made available for mergers and acquisitions. Private sector participation in these programs is possible through the Canadian Industrial Renewal Board (CIRB). While the textile and clothing industry is not at all typical of Canadian industry, the temporary measures used to help this very protected sector adjust to the gradual removal of trade barriers are useful examples of adjustment assistance.

One of the methods of adjustment assistance most frequently discussed by economists is the encouragement of specialization agreements, defined by the Economic Council of Canada as follows:

"A temporary agreement between firms to accomplish a restructuring of production and distribution with a view to increasing the scale and specialization of Canadian output and, in this way, reducing costs." (*Interim Report on Competition Policy*, 1969, p. 119)

The encouragement of such an agreement could be effected in a number of ways. For example, capital for reorganization could be provided in the form of government-backed loans, corporate income tax cuts, or accelerated depreciation allowances during the transition period. A specialization agreement itself could also take many different forms. The number of variations on the basic theme are only as limited as the collective corporate and academic imaginations of Canada and the United States. For example, does the agreement cover potential production as well as actual current production? Both goods and services? Clearly, specialization agreements are a very flexible method of response to competitive pressures.

As for their effectiveness in aiding adjustment to free trade conditions, it must be recognized that, irrespective of policy inducements, the removal of

trade barriers itself creates an incentive to specialize. This incentive is strongest when there are significant economies of scale yet to be achieved, as is the case in Canada. Aside from unit cost savings, the specialized firm is also more efficient in terms of management decision-making. As Dr. Fred Lazar of the Canadian Institute for Economic Policy said to the Committee:

"The more product lines you introduce, the greater the problems arising in managing the operations, the more decisions have to be made and the more decision modules in the corporate structure. [With specialization, you] have rather simple product lines, fewer decisions, and less complications and that makes for efficient management." (10:37)

Having described, in general, the need for adjustment assistance and some of the routes which might be taken to achieve it, the Committee emphasizes that government aids designed to further this objective must be part and parcel of the larger free trade agreement. Just as the variety of possible mechanisms of adjustment is virtually unlimited, so too is the number of policy options to encourage industry to make use of those mechanisms: government-backed loans or corporate tax credits may be given during the transition period; accelerated depreciation may be allowed, according to various formulas on certain types of capital expenditure; direct R&D grants and subsidies, or improved private sector access to specialized government research personnel and facilities—all of these could conceivably come within the ambit of an adjustment assistance program. It is, therefore, imperative that both parties to a bilateral free trade agreement be aware of and agree upon the specific policies open to each in providing industrial adjustment aid. These policies must not be allowed, unintentionally or otherwise, to act as instruments of protectionism in their own right as the United States now regards the safeguard clauses of the auto pact. One method of avoiding this possibility is to include 'sunset clauses' or limits to the duration of individual adjustment assistance measures, as part of the agreement establishing a free trade area.

Clearly, the issue of adjustment assistance will require detailed and complex negotiations if it is to be resolved in a manner which will both satisfy the parties and ensure that trade barriers are not permitted to persist in disguised forms. **However, in the Committee's opinion, the informed and intelligent implementation of an adjustment assistance strategy is a feasible and essential element of a Canada-U.S. free trade agreement. The Committee strongly recommends the formation of such a strategy, well in advance of the conclusion of bilateral negotiations, to facilitate both the conduct of the negotiations themselves and the planning decisions of Canadian industry.**

5. Subsidies

The Committee recognizes that the political and economic importance of many government subsidy programs would not vanish with the removal of

barriers to trade. Indeed, as has been noted above, they would become more important as part of an adjustment assistance program. But the provision of government subsidies to industry is a potential difficulty in any trade negotiation, particularly with the decline in the relative importance of tariffs. In the Tokyo Round negotiations, the participants found it impossible even to write a generally applicable definition of 'subsidy.' Over the years, in the Canada-U.S. trade context, there have been a number of disputes in this area, involving grants through the DREE and the PAIT programs by Canada and the DISC program of the United States.

In a free trade agreement, the question is, to what extent would Canada be compelled to accept standardization of subsidy arrangements? To what extent would Canada be able to keep its different forms of government aids to Canadian industry?

Opinions vary on the issue. Dr. David Dodge thought that with tariffs and non-tariff barriers removed, some degree of harmonization of the two countries' subsidies programs would probably be inevitable. The Hon. Larry Grossman was convinced this would happen. He was particularly concerned that, in order to stay competitive for investment purposes, Canada would have to adopt U.S. types of incentives and subsidies. Both Mr. Keating of Litton Systems and Mr. Tate of Garrett Manufacturing were apprehensive that, in a free trade agreement, other younger companies might not be able to benefit from the type of "financial leg-up" which they received from the government to launch their successful products.

The Committee is satisfied that neither harmonization of subsidies or an elimination of certain types of government aid need occur in a free trade setting. Other free trade areas such as EFTA have recognized that sovereign member states require different tools for their internal economic interventions. In this respect the testimony of Mr. F. H. Tyaack, a businessman with experience on both sides of the border, was instructive. He observed that each country had special problems and special needs. The United States protected small and minority-owned businesses; Canada had its DREE funding, and both countries supported R & D, although in different ways. He stated,

"I would not expect that you could write a practical bilateral agreement unless the other party recognizes your need. It is not just a matter of wiping out practices, but a matter of understanding what kinds of practices can be mutually tolerated under what sort of agreement. I think we underestimate the degree to which the original European Economic Community had all of those little matters in the background. They did not just wade into free trade. All their worries and concerns were documented and each knew its escape valve.

... If the other party has a strong need to do something then the other must allow him to do that within limits and according to agreements. . . . That is an approach which recognizes needs, but says that they should be described and a boundary put around them. . . . Having those things might be better than the impractical thing of trying to eliminate all to make a pure relationship, or having no agreement at all, because then one is constantly surprised." (16:27, 29)

Exactly. The Committee recommends that a free trade agreement should include a fairly explicit understanding of a balance of mutually tolerable subsidy programs, which could be retained without unduly frustrating the objectives of the agreement itself. Surely Canada and the United States need be no less flexible than European countries in free trade situations, in providing for special situations and anomalies which will naturally arise in an agreement of this kind.

6. Competition Policy

If Canada were to decide to move to free trade with the United States, small and medium-size Canadian firms would feel the need to merge in order to survive. At the time of this restructuring, an adjustment in the application of Canada's competition legislation would appear to be necessary.

Recent proposals for reform of Canada's competition policy would, if implemented, have the effect of bringing Canada's competition law much closer in line with that of the United States. The U.S. anti-trust enforcement is generally conceded as being much tougher than the present Combines Investigations Act. However, as the Committee warned in its earlier report, it is unwise for Canada to model its competition policy on U.S. laws. In the United States, while every industry is different, a yardstick used by many anti-monopoly advocates is that a company should not occupy more than 15 percent of the market of a given product. It is only necessary to point out that 15 percent of the U.S. market equals 150 percent of the total Canadian market to realize how inappropriate it is to base Canadian competition policy on U.S. policy. Application of the U.S. type of anti-trust policy in Canada would result in the continuation of inefficiently small firms, unable to compete with their much larger U.S. counterparts.

In the move to bilateral free trade, it would be important not to discourage rationalization through mergers of smallish Canadian producers. Even if the merging of several Canadian firms implied a monopoly position, there would be no difficulty in keeping the rationalized Canadian producer honest with the competition from U.S. producers across the border. Free trade would produce the necessary competition and protection for the consumer.

That being said, it is relevant to note that, in the past, competition policy has provoked disputes between Canada and the United States, particularly in respect to the extraterritorial impact of U.S. law north of the border. The suits filed in the United States regarding certain practices in the potash industry are a case in point. However, as an indication of the similarity of their respective legislation, the two countries were able to develop a comprehensive agreement on anti-trust modification and consultation procedure, the so-called Basford-Mitchell agreement. Nonetheless, U.S. firms with Canadian subsidiaries which would contemplate rationalization in the transi-

tional period could face prosecution under U.S. anti-trust laws as well as Canadian legislation. To avoid this danger, **the Committee suggests that the bilateral free trade agreement should contain provision that, during the transitional period, U.S. competition laws, as well as those of Canada, should be relaxed.**

A similar compromise would be necessary on the issues of conspiracy, monopoly, and other restrictive trade practices. Specialization agreements are in conflict with the legislation covering these issues at present. Although a transitional period for such agreements may not prove to be as easy to negotiate as for mergers, the imposition of a five to ten-year time limit on the duration of specialization agreements could greatly facilitate U.S. acceptance of the concept. By the time such specialization agreements came to an end, Canadian companies should have realized sufficient economies of scale to allow them to compete in the international markets. With the return to full enforcement of monopoly, conspiracy and restrictive practices legislation, Canada would have—for perhaps the first time—both competition and efficiency.

The Committee concludes that agreement on competition policy should be relatively simple to negotiate and would also prove to be a useful instrument of transitional adjustment.

7. The institutional structure

Very little testimony was taken on this subject but, because of its earlier study on the institutional framework of the Canada-U.S. relationship*, the Committee considers itself qualified to make several general points.

Neither the auto pact nor the defence production sharing arrangement provided for the establishment of a formal joint institution to be the custodian of the arrangements. As it turned out, particularly in the case of the auto pact, this was a mistake.** Serious confrontation, threats of abrogation and a series of industry inquiries could have been avoided if a mechanism had been established to monitor the performance of the pact, to recognize growing imbalances and distortions and to speak out on the counterproductive competition in respect to incentives for locational purposes.

Unquestionably a permanent joint monitoring mechanism would be required for a bilateral free trade arrangement. The Committee is doubtful that such a monitoring agency could be modelled closely on the International Joint Commission (IJC) with its collegial decision-making process in the face

* Canada-United States Relations, Vol I, *The Institutional Framework for the Relationship*, 1975.

** In its 1978 report, the Committee recommended the establishment of a Joint Automotive Monitoring Commission, to monitor the performance of the agreement, to modify procedure in minor ways and to help smooth and reconcile the differences between the two countries which have frequently been caused by unrealistic expectations of what the pact could do.

of the more complex and more confrontational nature of trade and investment issues. In the case of the IJC, both countries share a common goal even though priorities for achieving it may differ. The same is not true in respect to trade, where identity of interest will be rarer and each side would seek to maximize its own trade performance. These differences would render the establishment of a mutually agreeable mechanism more difficult. But a balanced monitoring agency would be fundamental to the successful operation of a free trade arrangement.

Any joint monitoring mechanism which is set up would be obliged to establish the facts. In this respect, the Committee suggests as a possible model, the Consultative Committee set up under EFTA. This group, composed not only of officials, but of representatives drawn from business and labour acted as a two-way channel of information between industry and labour on the one hand and the joint EFTA Council on the other.

In addition, it will be important to set up an appeal mechanism, a tribunal to rule on complaints and violations under the bilateral free trade agreement. Professor Lyon has pointed out that to attain the maximum degree of permanence, authority and effectiveness, a certain limitation on national autonomy, both American and Canadian, would be required. However, he considered that the United States would be unlikely to agree to a tribunal giving equal weight to both parties and having the power to make rulings which were in all cases binding. Instead, what would likely be attainable would be a joint body on which the two nations are equally represented, but whose important rulings would be taken as recommendations to the two governments, rather than binding rulings. Again, the Committee considers this is a realistic assessment.

PART VI

The Political Implications: Myth And Fact

The Committee is convinced that, economically, bilateral free trade is viable, that it would be of real benefit to all regions of Canada and that these advantages are widely recognized. What appears to deter many Canadians from the idea is a deep-seated fear of an erosion of Canadian sovereignty or eventual political integration. This ancient fallacy has dominated Canadian political life since the country was founded.

The government's 1972 'Third Option' paper represented a typical expression of the "inevitability of political union" point of view. It asserted that "free trade areas. . . tend towards a full customs and economic union" and that probably in a Canada-U.S. free trade area Canada would be obliged to seek political union. The claim was baldly stated and on this simple proposition the argument for closer economic ties was rejected. There was no analysis or examination of past experience in other parts of the world. A major Ontario government paper, *Interprovincial Economic Co-operation. Towards the Development of a Canadian Common Market* went even further:

"...the pursuit of free trade with the United States at the expense of an erosion of our ties to the rest of Canada would inevitably lead to the disintegration of our nation." (p. 13)

The Committee recognizes how widespread the misconception is. During the hearings, regional political representatives expressed these concerns about

diminished sovereignty and increased vulnerability to the U.S. giant. The Hon. Larry Grossman of Ontario was the most vocal of regional representatives in his reactions but the Hon. Roland Thornhill of Nova Scotia and Dr. James McNiven of the Atlantic Provinces Economic Council also expressed concern for the country's political sovereignty and suggested that the east-west ties in the country would be diluted in a free trade arrangement. The Hon. Hugh Planche of Alberta was cautious about a one-to-one situation and the implications it would have on the integrity of Canadian decision-making. Similar apprehensions seemed to be a central element in the preference of certain other witnesses for a multilateral rather than a bilateral approach to trade liberalization. It is an "in bed with the elephant, it is safer to have supporting friends with you" type of argument.

What are the facts? Having studied past international experience in free trade areas, Professor Peyton Lyon told the Committee that both **"history and logic refute the claim that free trade areas inevitably unleash economic forces that drive the participating nations, against their will, on to tighter forms of economic and political union."** Documenting his case, Professor Lyon concluded that **"far from being typical there is no single, solitary case of this ever having happened."**

Free trade areas do not tend to become customs unions; they do not become politically integrated. On the contrary they are "characteristically established by governments determined to achieve gains while retaining as much national sovereignty as possible," said Professor Lyon. Moreover, even countries which have organized into the much more tightly structured arrangement of a customs union or a common market, with the expressed aim of some degree of political integration, have met with frustration and difficulties in achieving their aim. Some scholars even argue that economic integration may impede political integration, Professor Lyon reported.

The Hon. Robert Stanfield also disagreed with the perception that Canada's sovereignty would be diminished in a bilateral free trade situation, although he recognized it has been dangerous, politically, over the years to propose reciprocity with the United States. He told the Committee he believed a shared market between the two countries would help strengthen Canadian national feeling and reduce regional tensions. But in view of the common Canadian misconception on the sovereignty question, and the fact that Canadians have been slow to examine it carefully, Mr. Stanfield urged its active debate.

"Some people who are strong economic nationalists will dismiss it immediately on, perhaps, emotional grounds; others who are traditional free traders will accept it on their faith and principles; but my belief is that most Canadians are not sufficiently informed on the subject today to have any firm opinion or be at all certain as to what the indications are. I think there is a lot of educating and a lot of thinking to be done . . ." (5:23)

Both Mr. Stanfield and Professor Lyon made the point that Canada is already dependent on the United States in the sense of concentration of sales to one market, an inescapable result of a geographic fact of life. Consequently, Canada is even now vulnerable to policy changes by the U.S. government in import regulations, quotas, tariffs, non-tariff measures, etc. Canadian decision-makers are at present constrained to a considerable degree by this reality whether they like it or not. Former political leaders have acknowledged it. To reduce the existing dependence, Mr. Stanfield said, would only result in a far lower standard of living in Canada and in a diminishing opportunity for national prosperity. Most Canadians appear ready to accept the current degree of economic dependency.

Contrary to the popular myth, it is precisely a free trade arrangement which could give Canada a lessening of this kind of constraint. With a carefully defined and structured free trade arrangement with Canada, the United States would be much less likely to hit its partner with sudden reversals of trade policy. If Canadian policy makers are worried about a tightening up of procurement rules, for example, what better way to get at it than through the mechanism of a free trade agreement and the appeal mechanism provided therein? A good case can be made that Canada would actually have more influence in Washington and more independence of policy under a free trade agreement than it currently has without it. Recalling the abrupt imposition in 1971 by President Nixon of a 10 percent surcharge on all dutiable imports to the United States, an American economist told the Committee that Canada would have been exempted had it been a free trade partner. Nor did he think that U.S. government procurement could be as discriminatory as at present against a free trade partner.

It is difficult for the Committee to understand the viewpoint that the removal of the remaining tariffs could have such momentous political effects as its critics claim. It is, after all, only a small part of the total economy which would be affected—namely a part of the secondary manufacturing sector, badly in need of assistance. Almost 80 percent of Canada-U.S. trade will soon be free of tariffs in any case. Canada has gone this far toward tariff free trade without any awful consequence to its independence and sovereignty. Why would the freeing of the last 10 to 20 percent have such disastrous effects? Where is the evidence that, as Mr. Grossman put it, “Canadian cultural values, traditions and social and political choices would disappear and be swallowed up”? The Committee wants to see these values protected and enhanced. Is there not more basis for saying that an improved economic situation resulting from a successful bilateral free trade arrangement would give Canadians more confidence, more strength to resist pulls from the United States including those of Canada’s educated youth migrating south to more interesting job opportunities. **The strongest industrial areas in Canada, both in resource-based and manufacturing sectors, are those with no tariff**

protection; it is only the weaker manufacturing areas which are protected and if these industries are restructured and strengthened through free access to the U.S. market it could only strengthen the Canadian social and political fabric as well as its economy. Would anyone suggest that Ireland (Eire) had lost any of its political or cultural independence after it joined the United Kingdom in a bilateral free trade arrangement? It certainly became economically stronger.

Another concern which has been raised is the fear of abrogation by the United States of a bilateral free trade agreement. The argument goes that since, under free trade, the concentration of Canadian trade in the U.S. market would be greater than it is now, the reintroduction of tariffs or other trade restrictions would be dangerously costly to Canada whereas the United States would hardly notice it. This 'irreversibility' of the arrangement for Canada, the fact that the United States holds Canada's main markets as 'hostage', it is maintained, would give the United States potent leverage in bilateral negotiations.

First, as Professor Lyon pointed out, the U.S. record of adherence to treaties is relatively good. Secondly, a bilateral agreement could explicitly spell out that any intention to terminate the agreement should necessitate a specified warning period and this should be long enough to ensure there would be no sudden shock of termination. Third, even in the unlikely and unfortunate event that the United States did terminate the agreement, how vulnerable would Canada actually be? Most proponents of bilateral free trade consider that one of the most important reasons to go this route is the need to jolt the vulnerable secondary manufacturing sector into reorganizing and restructuring. Once this adjustment had taken place under a Canada-U.S. agreement, the Canadian manufacturing sector would have been forced to rationalize and would thus have strengthened itself. Even if the United States were to reimpose its tariffs (and they would be the MFN tariffs lowered meanwhile under the GATT agreement by as much as 40 percent), Canadian industry should be better able to compete than it is now. Thus, even in the 'worst scenario' case and no matter what the final outcome, the Canadian manufacturing sector would be stronger than it is today and with a better future outlook.

Finally, the United States has a major stake in Canadian prosperity. Currently it is very angry at certain Canadian policies which it sees as 'discriminatory' and is threatening to retaliate. But it is finding it quite difficult to do so. Like Gulliver, the United States is constrained by a network of strings—links which weave its own economy to that of Canada. Retaliation risks inflicting damage on itself since almost 25 percent of its exports go north to Canada. With free trade, this constraint on U.S. retaliatory action

would be strengthened, making abrogation of a treaty a very unlikely development.

Nor is Canada without some leverage of its own. U.S. industry is highly dependent on a wide range of Canadian resources. Canada's control over future sales of such resources is in itself a strong bargaining counter. Moreover, as Professor Wonnacott has pointed out, the extent of U.S. direct investment in Canada gives Canada the power to retaliate swiftly—with a tax on U.S. subsidiaries for example—if the United States arbitrarily and unilaterally reimposed the tariff which Canada would view as a tax on its industrial output.

What about the concern that foreign ownership would increase under bilateral free trade—that the stronger foreign corporations with better financing possibilities and established markets would be able to survive the rationalizing moves of the Canadian manufacturing sector and would consolidate smaller unviable Canadian firms during the initial adjustment period? Most economists agree that indeed this could be a short term danger and that it would be reasonable to negotiate short term controls into the agreement for the period immediately following tariff reform. As noted on page 99, it might be necessary to modify competition rules and allow greater freedom for Canadian firms to merge during the transition period. Concerns over competition would be diminished since the Canadian consumer would be protected from a Canadian monopoly situation by the availability of duty free imports. The Economic Council has also suggested that, because influences such as emotional nationalism might possibly adversely affect the location decisions of U.S.-owned firms under bilateral free trade, some form of review procedure could be justified for the transition period.

Over the long term, however, the prospects for strengthened Canadian ownership look good as multinationals would feel free to choose to service the whole North American market from Canada. At present, it is mainly the successful Canadian multinationals in the resource sector or in certain high technology areas already benefitting from special tariff-free access which have remained in Canada. For many others, the U.S. tariff has prompted a move southward.

Finally, any discussion of the free trade and foreign ownership issue necessitates setting the record straight. **It has been, after all, the Canadian tariff which has resulted in the high degree of U.S. ownership in Canada's manufacturing sector and the creation of 'branch plant' companies. Had free trade been adopted much earlier, the story could have been quite different.**

The necessity for harmonization and co-ordination of policies of the two countries in a free trade arrangement was another concern broached during Committee hearings. The Hon. Larry Grossman argued that in order to

ensure that the investments of multinationals came to Ontario or Quebec and not to the north-east United States, it would be necessary to adjust Canadian standards or policies to conform with those of the United States; for example in respect to minimum wage rates, environmental standards, revenue bond financing, etc. To what extent, asked the Hon. Roland Thornhill of Nova Scotia, could Canada's policies on regional development subsidies be maintained? What about Canadian content requirements, FIRA, industrial incentive programs? Other witnesses were worried as to whether corporate taxes would need to be the same in both countries in order to avoid taxation levels being a factor in plant location or to avoid giving an unfair competitive advantage to one country? Would Canada be forced to have the same unemployment insurance and workmen's compensation schemes as the United States? Would U.S. 'set-asides' for small businesses be maintained? Would Canada be able to maintain an independent foreign policy?

Many of these points are well taken and the Committee heard a variety of opinions on them from expert witnesses. The balance of evidence was that the two countries' taxation and fiscal policies could remain as they were and the differences, as they affected trade, could come out in the exchange rate. Professor Lyon stated that only a modest amount of policy co-ordination had been found desirable in most free trade areas. Dr. David Dodge considered there might well be some pressure for Canada to standardize its subsidy and tax arrangements with those of the United States. In Washington, while Professor Robert Dunn told the Committee that even FIRA would not constitute a major problem in a free trade arrangement, other American witnesses expressed concern that it could cause problems.

In actual fact, relatively little policy harmonization has been required in EFTA or in other free trade areas. Even the small European countries like Sweden and Norway, which have free trade agreements with the huge European Community, show little evidence of conformity to it either in matters of economic or foreign policy. Even within the Community itself, which as a common market, not a free trade area, has sought policy harmonization, there is not a high degree of uniformity. That free trade is not dependent on taxation conformity is evident from the differing tax systems within the individual states of the United States. But even to-day Canada cannot allow its competitive position, with all its different components including wage and productivity rates, taxation rates, etc., to vary too much from that of the United States without suffering the consequences of a falling dollar and falling investment. A free trade arrangement would not substantially alter this situation.

The most sensible approach to the issue of policy harmonization was one suggested by a businessman familiar with the situation on both sides of the

border. Mr. F.H. Tyaack of Westinghouse, Canada said that in negotiations, both sides would be worried about the other side's existing policy on this or that. But he said:

"Each country has certain problems, economically and in other respects . . . In recognizing the needs of the other party you can have a reciprocal agreement which recognizes needs and condones practices. This is another avenue than just assuming that they must be eliminated. You cannot eliminate needs. . . Therefore, I would not expect that you could write a practical bilateral agreement unless the other party recognizes your need. It is not just a matter of wiping out practices, but a matter of understanding what kinds of practices can be mutually tolerated under what sort of agreement." (16:27)

As to whether bilateral free trade would diminish the independence of Canadian foreign policy, it must first be noted that Canada's present foreign policy formulation is constrained, as is that of all the countries of the western industrialized world, by their existing economic and military interdependence. As one witness said, existing precedents do not lend support to those who fear a diminished independence. Under a free trade agreement Swedish foreign policy has been quite different from that of other EFTA members for example. Even with 70 percent of its exports and imports tied to the United States, Canada has differed from the United States on many issues in NATO and in the United Nations. Canada has pursued policies toward Cuba and China which were not to the United States' liking. Professor Lyon pointed out that Australia, which is much less dependent on the U.S. market than Canada, has had a less independent foreign policy than Canada, perhaps because of its different strategic position. Australia may consider it should try to align its policies with those of the United States in view of its defence dependency, whereas Canada assumes that, as a close neighbour, it will continue to benefit from joint defence agreements. The Committee finds it difficult to understand why the lifting of remaining tariffs should make a difference to Canada's foreign policy stance. On the contrary, a persuasive case can be made that, if a formal bilateral free trade agreement strengthens the Canadian economy, Canada's ability to pursue an independent foreign policy would be strengthened, not weakened.

To sum up, the Committee is convinced that a hard-headed assessment is needed for this emotionally-charged issue. A great deal of educating needs to be done. That Canada's prosperity and standard of living are dependent to a very great extent on U.S. markets, no one can deny. For the majority of Canadians, this appears to pose no problem even though it may concern Canadian, and even American, decision-makers from time-to-time. But to jump from this to the conclusion that the removal of the remaining tariffs and the increasingly troublesome non-tariff barriers would lead to political integration with the United States is totally unwarranted by the facts.

In the Committee's opinion, a far more potent threat to Canada's political and social strength would come from a continued weakening of its indus-

trial performance and a decline in its economic stability in the face of the challenge of the 1980s and 1990s. It is precisely at the strengthening of the national fabric, both political and economic, that a Canada-U.S. free trade arrangement is aimed.

PART VII

Summary

Background

Among the recommendations made by the Committee in its 1978 report (Volume II) on Canada-US trade relations was one which urged the governments in Canada as well as the business and labour communities to examine seriously the option of bilateral free trade with the United States. In its more recent study, the Committee has held a series of hearings with businessmen, academics and trade negotiators, both Canadian and American, as well as representatives in various regions of Canada, in order to examine reactions to such a policy course and to determine what the best approach to achieving such an objective would be.

While there is general awareness of the importance of trade to the Canadian economy, with exports alone constituting 26 percent of the Gross National Product, what is sometimes lost sight of is that, of Canada's total trade, almost 70 percent, or \$100 billion, is with the United States. The Committee wishes to stress that if there is a problem—and surely there is, with a deficit of trade in end products of \$20 billion—it is in the United States market that the solution to the problem must be found.

In its review of ground covered in Volume II, the report briefly notes what the Committee considers to be the main problems besetting Canadian industry, particularly the manufacturing sector, in the present international

trading environment: the fragmentation and inefficient structure; the widespread lack of specialization in product lines; the lack of economies of scale and the relatively low productivity rates.

Conclusions and Recommendations

1. Since the Committee published Volume II, a major new factor to the agreement reached at the GATT Multilateral Trade Negotiations during the Tokyo Round providing for deep cuts in **tariffs** by Canada and its major trading partners to be implemented in stages by 1987. When fully implemented, they will result in major challenges for many industries, in the Canadian manufacturing sector in particular, from increased import competition. They should also provide important new export opportunities. But for some sectors—notably the petrochemical—many high tariffs have not been lowered.
2. In respect to **non-tariff barriers**, the GATT negotiations made only limited progress in bringing them under control. In terms of Canada-U.S. trade, there are a number of major non-tariff problems which were not resolved by the Tokyo Round. **In fact, U.S. non-tariff barriers appear to present a more serious problem for Canadian industry now than before the GATT negotiations and a much more serious problem than those tariffs which will remain in 1987.**
 - a) In respect to countervail, the Committee sees the need for a bilateral negotiation with the United States in order to deal with the uneven impact of countervail in the two countries; to decide exactly what constitutes a permissible subsidy; and to explore the possibility of the United States continuing to apply an 'offsetting' mechanism in respect to the use of countervail against Canada.
 - b) U.S. procurement laws and regulations are seriously hurting Canadian industry. The Committee has determined that there is an urgent need for the government to negotiate with the United States on a bilateral basis in order to try to put this country in a special category in respect to the application of U.S. procurement rules.
 - c) The Committee considers that customs valuation problems between Canada and the United States, arising from the GATT Tokyo Round, warrant special bilateral arrangements to resolve them.
 - d) Canada should make an effort to come to a bilateral arrangement with the United States in regard to DISC since multilateral negotiations have not succeeded in resolving this problem.
 - e) The new complex, legalistic, regulatory system recently put in place in the United States gives U.S. producers recourse to pro-

fective measures which will not be easy to overcome. The Committee considers that Canada must find some way of "getting inside" the whole legalistic trade regulatory system now in place in Washington.

The Committee is convinced that the only way to deal effectively and soon with these and other serious U.S. non-tariff barrier problems is through a bilateral arrangement with the United States.

3. The Committee considers that the achievements of the Tokyo Round in liberalizing trade appear unlikely to provide sufficient stimulus to bring about the necessary restructuring and rationalization of much of Canadian industry, particularly the vulnerable manufacturing sector. **The Committee concludes that the Tokyo Round has, in effect, left Canadian industry in the worst of both possible worlds—with tariffs too low to be an effective protection and, at the same time, still without free access to a huge assured market as enjoyed by its competitors, the European Community, Japan and the United States.**
4. The Committee considers that government measures to strengthen the position of Canadian industry are not generally having the desired effect of stimulating the growth and competitiveness of the Canadian manufacturing sector and are having the added disadvantage of arousing strong critical reaction from the United States. **The Committee therefore reaffirms the conclusion reached in its Volume II report that the desired restructuring, growth and competitiveness of Canadian industry can best be achieved by the negotiation of a bilateral free trade agreement with the United States.**
5. The Committee concludes that there has been a remarkable growth in self-confidence in the Canadian business milieu in respect to the question of bilateral free trade which has not yet permeated the political milieu.
6. **The Committee emphasizes that what it is recommending is a bilateral free trade agreement, not a common market or a customs union.** There are important differences which many Canadians fail to recognize.
7. The Committee considers that what Canadian industry needs above all else is dependable access to the U.S. market and with preference in that market over both the advanced industrial countries of Europe and Japan and the fast growing, newly industrialized countries.
8. **The Committee concludes that a bilateral free trade approach is preferable to a multilateral approach** because, among other reasons, multilateral free trade is clearly not achievable in the near future. Another full-

scale MTN is not likely before the mid-1990s, and in any case, Canada's interests are unlikely to be served by what has become a 'club of three,' that is the European Community, the United States and Japan.

9. **The Committee concludes that any arrangements for a free trade area between Canada and the United States should comply with GATT rules and precedents.** Under GATT rules there are various policy options for entering into a bilateral free trade agreement:

- a) A 'pragmatic' approach by Canada and the United States to specific bilateral issues under the GATT conditional most-favoured-nation (MFN) procedure; that is, the resulting benefits of freer access concluded by the two countries would be accorded automatically to those other countries which were themselves prepared to offer the same benefits.

The Committee rejects the 'pragmatic' approach because it appears difficult to achieve under GATT rules and is unlikely to interest the United States.

- b) A 'declaratory' approach under Article XXIV of the GATT whereby the two countries would issue a declaration saying that a free trade area as defined by the GATT should be now deemed to exist between Canada and the United States. From there they could proceed to further liberalize trade by sector or product.

In respect to the declaratory procedure, the Committee noted that, by 1987 when the agreed GATT tariff cuts will become fully effective, a ***de facto* free trade area between Canada and the United States in respect to tariffs could be said to exist.*** This would mean that the two countries could, within the meaning of the GATT definition, declare they already qualified as a free trade area, as far as duty-free trade was concerned, and proceed to liberalize trade further at their own pace. However, since non-tariff barriers, which are now an even more important determinant of trade than tariffs, would not be taken account of, the declaratory approach would not serve Canada's best interests.

The Committee rejects the 'declaratory' approach.

- c) An 'interim agreement' approach under Article XXIV, under which the two countries would submit to the GATT a plan and schedule for the formation of a Canada-U.S. free trade area. Such a procedure would deal with non-tariff barriers as well as tariffs. Further,

* The GATT has previously acquiesced in the formation of free trade areas with a lower level of freely traded goods than would actually exist between Canada and the United States by 1987.

the 'interim agreement' procedure is the one used for all previous regional free trade arrangements under the GATT.

The Committee recommends the adoption of the 'interim agreement' approach.

10. The Committee concludes that the free trade agreement should be drawn up initially only between Canada and the United States, but that it could be couched in North American terms so that if and when Mexico is ready to offer comparable access conditions, it could become part of the North American free trade area.
11. The Committee concludes that there is a growing receptive audience in the United States to such an initiative from Canada for bilateral free trade.
12. In respect to the economic impact of free trade, there would be substantial benefit to the resource and resource-based industries. The initial dislocating effect of bilateral free trade would be confined mainly to Canada's secondary manufacturing sector. Some companies would contract and others would expand. **The most important and basic economic benefit of bilateral free trade would be to assist industrial restructuring in Canada, which would result in an industrial establishment equipped to compete effectively, not only in the United States but also in world markets and in the Canadian home market.**
13. As far as foreign-controlled firms are concerned, the Committee considers that the bilateral free trade environment would make rationalization easier and more attractive for foreign-owned subsidiaries in Canada. Product mandating assignments would also be easier where tariffs are eliminated and the application of non-tariff barriers mutually agreed and enforced. To the extent that rationalization and product mandating are pursued by subsidiaries, the likelihood of repatriation of such plants to the United States is lessened.
14. **The Committee is convinced that, in a bilateral free trade setting, Canadian manufacturing firms, particularly in high technology, would be less likely than at present to locate branches in the United States, would do more R&D in Canada and would be better able to serve the U.S. market from Canada.**
15. In the report, the Committee has pointed to **areas of special concern** to which particular attention should be paid if Canada is to enter a bilateral free trade agreement with the United States. These areas are: the level of Canadian competitiveness, the question of Canada's place in the world technology race, Canadian non-tariff measures, foreign investment, the exchange rate and tax harmonization. In each of these potentially difficult areas, the Committee has commented on how Canada's

interests could be affected and in some cases suggested courses of action which could be followed.

16. In the report, the Committee has commented on a number of conditions which it considers should be included in the bilateral free trade agreement with the United States. These are:
 - a) **Timing and scope:** The Committee recommends that Canada should endeavour to have as many non-tariff barriers as possible eliminated forthwith and should endeavour to have tariffs eliminated over a transition period of 8 to 10 years. In addition a faster rate of elimination of U.S. tariffs than of Canadian tariffs should be sought.
 - b) **Rules of origin:** While Canada must protect itself from trade diversion, in view of the fact that U.S. tariffs against third countries would be generally lower than Canada's, the rules of origin written into the agreement should nevertheless be fairly liberal, in order to give Canadian manufacturers the possibility of continuing to source imports from the least-cost supplier.
 - c) **Exceptions and safeguards:** The most notable exception in the bilateral agreement would be agriculture. Safeguard clauses should be included to permit either country, when faced with disruptions in particular sectors, due to tariff cuts, to impose quantitative restrictions, provided rigid requirements are met. It might also be necessary to negotiate guarantees for Canadian employment during the interim period, with a rigid time limit set on their duration.
 - d) **Adjustment assistance:** The Committee considers that a well-prepared program of adjustment assistance to affected industries would be an essential element of a Canada-U.S. free trade agreement.
 - e) **Subsidies:** The two countries should come to a fairly explicit understanding of a balance of mutually tolerable subsidies which answer each country's needs.
 - f) **Competition policy:** The Committee suggests that the agreement should contain a provision that the enforcement of both Canadian and U.S. competition laws should be selectively relaxed during the transition stage.
 - g) **The institutional structure:** The Committee considers that a joint monitoring agency would be fundamental to the successful operation of such a bilateral free trade arrangement. In addition, it would be important to have an appeal mechanism, to rule on complaints and violations.

17. The Committee found that regional reactions to the idea of bilateral free trade varied, with considerable caution being expressed by regional politicians—a caution seemingly based less on a negative economic assessment than on the fear of a possible erosion of Canadian sovereignty. In fact, overall, the evidence pointed to some economic gains for all regions in Canada from bilateral free trade. The biggest dislocation would affect and, at the same time, the biggest gains would accrue to, the two central provinces.
18. The Committee concludes that the widespread fears among Canadians that bilateral free trade with the United States would lead to an erosion of Canadian sovereignty, or eventual political integration, are based on misconceptions and a lack of facts as to what constitutes a free trade area. The Committee is convinced that a hard-headed assessment is needed for this emotionally-charged issue. (Part VI of the report deals specifically with this problem)

A great deal of educating needs to be done. No one can deny that Canada's prosperity and standard of living are dependent to a very great extent on U.S. markets. For the majority of Canadians this appears to pose no problem, even though it may concern Canadian, and even American, decision-makers from time-to-time. But to jump from this to the conclusion that the removal of the remaining tariffs and increasingly important non-tariff barriers would lead to political integration with the United States is totally unwarranted by the facts.

In the Committee's opinion, a far more potent threat to Canada's political and social strength would come from a continued weakening of its industrial performance and a decline in its economic stability in the face of the challenge of the 1980s and 1990s. It is precisely at the strengthening of the national fabric, both political and economic, that a Canada-U.S. free trade arrangement is aimed.

APPENDIX A

The Impact of the Tokyo Round on Canadian Industry

a) Tariffs

One of Canada's main objectives at the MTN had been to gain the elimination of duties on its more processed exports from the forest products, petrochemical and non-ferrous metals sectors. To this end it had proposed across-the-board sectoral negotiations encompassing both tariff and non-tariff barriers. Even though Canada tried to use the idea of security of supply as a leverage, its sectoral initiative was rebuffed. Part of the problem may have been unlucky timing, since the negotiations took place during a period when raw material supplies seemed readily available. Canada's bargaining power might have been stronger had there been a strong world market demand for resources or resource-based products.

In the resource sector, only minor concessions were gained for non-ferrous metals, apart from the elimination of the U.S. duty on aluminum ingots. Nor was much progress made in obtaining easier access to markets in the United States for Canadian specialty steels on which there is a U.S. import quota. On most asbestos products, the United States agreed to eliminate duties. In the forest products sector, however, Canada had more notable success in gaining improved access for a wide range of processed exports, particularly to the United States, but to a lesser extent also to Japan and the European Community. For example, U.S. tariffs on dutiable wood products will fall from an average of 6.2 to 0.8 percent; its tariff on waferboard and

particleboard from 10 to 4 percent, on hardboard and birchfaced plywood from 7.5 to 3 percent. The U.S. tariff on stained and pre-finished lumber and on birch and maple wood veneers will drop to zero. The duty-free U.S. access currently granted to newsprint and several other papers will be extended to certain other paper products, including an important kraft paper item, and the average U.S. tariff for paper and paper products will fall from 3.8 to 0.8 percent. On the whole therefore, access to U.S. markets should be easier for processed forest product exports, subject only to the possibility of increasing use of non-tariff barriers by the United States.

On certain manufactured products, Canada made significant concessions. While the domestic appliance industry will still retain a protective tariff in the range of 12.5 percent, down from 15 to 20 percent, the Canadian rates on imports of electrical and electronic office equipment such as cash registers, adding machines, typewriters, dictating systems will drop to zero from 10 to 20 percent. Computers and related products now protected by duties ranging up to 17.5 percent, will have duties of from 3.9 percent to zero, roughly paralleling U.S. tariffs in these items.

For furniture, the United States made substantial concessions in tariffs on both metal and wood furniture which may benefit the Canadian furniture manufacturer. Canada also agreed to reduce its furniture tariffs, down to the 10 to 15 percent range, a level still well above the U.S. rates.

In the transportation sector, the MTN could result in stimulus for automotive parts companies when market conditions improve. Both Canada and the United States agreed to tariff reductions which will affect aftermarket parts outside the auto pact. Significant cuts on auto parts duties were also agreed to by Japan and the Community. No reduction by Canada or the United States was made in their high tariffs on rail cars.

For the Canadian machinery industry, the United States is a major market, accounting in 1978 for 41 percent of sales and 72 percent of exports. Under the MTN, the United States will provide duty free access for a broad range of machinery for the pulp, paper and paperboard industry, for ingot moulds and casting machines and for fork-lift trucks and platform trucks. Duties on a number of other machines will be reduced. Some important Japanese and EC tariff reductions were also made on a number of machinery items. The United States agreed to open wider its agricultural machinery market for Canadian exports. Canada currently provides duty-free entry for a much broader range of U.S. agricultural equipment than the United States provides for Canada. At the Tokyo Round, the United States agreed to establish an 'actual use' provision in the U.S. tariff which will ensure that most Canadian exports of agricultural machinery and equipment will enter free of duty provided they are for agricultural use. In the past, the restrictive

application of this provision has constituted a considerable non-tariff barrier for Canadian agricultural machinery exports.

Canada made a major concession in respect to its Machinery Program which was an important factor in reaching an agreement with the United States concerning access for farm machinery, a long-standing trade irritant between the two countries. Under the existing Machinery Program, Canada makes a distinction between machinery imports which compete with Canadian products and those which do not. The former imports faced a duty in the 15 percent range; the latter came in free. Canada has now agreed to reduce the tariff on many items of machinery available in Canada to 9.2 percent from 15 percent and to bind the average incidence of duty on imports under the Machinery Program at 5.25 percent. In addition, for a significant number of machines which have been entering Canada free, but unbound, for many years, Canada has agreed to bind these zero rates.

In the chemicals sector, a Canadian objective had been better access to the U.S. petrochemical market for its burgeoning petrochemical industry. This objective did not succeed and, in general, both Canada and the United States retained a high degree of protection in this sector, with some U.S. tariffs on petrochemical derivatives moving even higher.

In the agricultural sector, concessions from the major trading partners will affect \$1 billion worth of Canadian exports and considerable benefits were achieved for fisheries and alcoholic beverages, particularly whisky in the U.S. market.

In sum, for numerous sectors, the lowering of Canadian tariffs will mean that consumer goods and industrial products will flow in more easily and cheaply. But the traditionally protected Canadian manufacturing sector will be rendered more vulnerable to import competition. The most sensitive industries, such as textiles and shoes, are still heavily protected.

In respect to the agreement on Trade in Civil Aircraft, there will be little adjustment required by Canada since existing tariffs on most aerospace products have not been applied for many years. Considerable stimulus for the Canadian aerospace industry is expected therefore from the duty free access provisions. At the same time, the non-tariff provisions of the agreement will allow a continuation of the government's program of support for the industry and the opportunity to seek reasonable offsets in major civil aircraft purchasing contracts. Production and trade in military aircraft are not covered by the agreement.

b) Non-tariff barrier codes

The non-tariff barrier arrangements concluded at the Tokyo Round included agreements on subsidies and countervailing duties, technical barriers

ers such as product standards to trade, government procurement, import licensing, and customs valuation; a revised agreement on anti-dumping duties; and a framework of understanding covering ways in which certain GATT obligations should be applied and a strengthened dispute settlement procedure.

(i) Countervail

The new GATT subsidies/countervail agreement recognized that subsidies are a legitimate tool for the promotion of such national objectives as regional development, research and development and industrial restructuring. It also introduced better international discipline in the use of subsidies which affect trade and production.

In respect to the United States, the new agreement is unlikely to solve Canada's bilateral countervail problems despite the U.S. acceptance, at the Tokyo Round, that it will henceforth conform to the GATT procedure of establishing whether or not 'material injury' has been done to a domestic producer before imposing countervail duties. Formerly, the U.S. government could, under a U.S. law which preceded the GATT procedure, arbitrarily impose duties against exports from Canadian firms benefitting from government-funded programs whether or not they had caused injury to domestic producers. Two notable examples in the 1970s which caused considerable bilateral strain concerned Canadian exports to the United States by the Michelin and Honeywell companies. An important Canadian objective in the Tokyo Round negotiations had been to gain U.S. conformity regarding the finding of 'injury'.

Professor Fred Lazar of York University told the Committee that the new U.S. conformity could be "a hollow victory" since the U.S. Trade Agreements Act of 1979 was amended simultaneously to make it much easier for U.S. companies to lodge complaints and for the International Trade Commission (ITC) to find injury. The ITC can now find injury from foreign export subsidies and order countervail duties or tariff quotas as long as there is even a marginal relationship to the fact that a U.S. producer's performance has deteriorated, he said. Similarly, Professor Lazar made the point that the revisions to the existing GATT dumping code, while including the same injury test as the subsidies code, has been watered down by the United States. It no longer requires sales at less than fair value to be the principle cause of poor performance of firms in the country in which the goods are being dumped. Instead, the U.S. legislation only requires the establishment of "a weak and perhaps indirect link between dumped goods and poor market performance". Whether the Administration will apply these rules strictly remains to be seen.

Another concern in respect to countervail, emphasized by Mr. Rodney Grey, involves the asymmetry of the impact of countervailing action by the two countries. In Canada, because of the high cost of capital and serious regional disparities in income and employment, there is a continuing need for both federal and provincial assistance to industrial development. But since a large percentage of the Canadian production must be exported, and as by far the largest market is the United States, the risks of running into U.S. countervail action, if rigorously applied, are great. For the United States, on the other hand, subsidization of industry, done via methods such as tax-free municipal industrial revenue bonds or tax-free land, is directed mainly at production for the internal domestic market, rather than for export to Canada or elsewhere. Thus, although Canada now has a countervail law, it is not likely to be frequently used, nor will it constitute much of a threat to U.S. industrial development.

In contrast, vigorous application of the U.S. countervail law against Canada could have a very serious impact, not only on industrial production by requiring producers to try to rely on a protected Canadian market, but on location of production in Canada. For example, any firm accepting a subsidy and locating in Canada with the intention of producing for the North American market runs the risk of U.S. countervail on about 80 percent of his output. However, for a similar firm also subsidized, located in the United States, there is a risk of possible Canadian countervail on only about 10 percent of its output. In the face of this risk, Canada can lose industry. Canadian subsidiaries of U.S. multinationals may choose to locate new production in a corporation's U.S. plants rather than in Canadian locations. From Canada's point of view, the GATT countervail code appears inequitable in its application.

Although the GATT prohibits export subsidies, the Tokyo Round did not succeed in defining what constitutes a subsidy, although it gives some examples. As a result, many anomalies remain. Mr. Grey has pointed out*, a Canadian DREE subsidy, while not inconsistent with the GATT code, is nevertheless vulnerable to countervail. But general tax incentives applied across the country, or the provision by a province or state of required infrastructure for an industrial site, or subsidies to an industrial project which are fully repaid do not appear to be subject to countervail. On the other hand, tax incentives for location in designated regions, or extension of credit at less than the going rate of interests, or the financing of industrial R&D if it appears to help the commercial production and marketing of a product would seem, by precedent, to be subject to countervail.

* Rodney C. Grey: *Trade Policy in the 1980s: An Agenda for Canadian-U.S. Relations*, C.D. Howe Institute, 1981, p. 56-7

Mr. Grey has pointed to another retrograde step involving U.S. countervail law occasioned by the Tokyo Round. Earlier, the U.S. Treasury had developed, partly as a result of discussions on the Michelin case, the concept of 'offsetting' in calculating the amount of countervail duty. That is, it would consider as a subsidy only that amount in excess of the higher cost involved in locating a plant in less than a prime location, thus taking into account the fact that regional development grants were legitimate national policy actions. Had this method been applied, for example, in the Michelin case, and the extra costs involved in establishing a plant in Nova Scotia rather than in Ontario or Quebec been deducted from the DREE subsidy, the net subsidy might have been calculated as very much lower or perhaps not even subject to countervail. Unfortunately, the Congress in passing the 1979 U.S. Trade Agreements Act, aiming at the European Community and not at Canada, outlawed the 'offsetting' concept, a move which makes U.S. countervail potentially much more punitive for Canada.

(ii) Procurement

From the Canadian perspective, the agreement on government procurement, while technically well set out, proved a major disappointment because of its very limited coverage. As Mr. Grey admitted to the Committee, "the procurement code does not cover very much procurement".

What the procurement code **does** cover is purchasing by major U.S. and Canadian federal government departments as well as a range of other agencies and commissions for goods valued above approximately Cdn. \$220,000. (This represents some control on only about five percent of the Canadian government's purchasing and probably the same amount in the United States.) An attempt has been made in the code to ensure more "transparency" in procurement procedures and bidding techniques. There is also a provision in both the code and the U.S. Trade Agreements Act for further multilateral negotiations to take place before the end of 1983 in respect to procurement.

What the code **does not** cover includes state and provincial purchasing, purchases by commercially-operated crown corporations and comparable arm's length corporations, government agencies in the United States, and purchasing subject to national security considerations. Important U.S. government purchasing entities, such as the Tennessee Valley Authority and Amtrak are not covered. These would normally be the prime market for the sort of products Canada excels in, namely, heavy electrical generating equipment, rapid transit and railroad equipment, etc. Telecommunications equipment is not covered. Purchases of items under Cdn. \$220,000 or U.S. \$190,000, are not covered, nor are construction or service contracts. The U.S. set-asides for small and minority-owned businesses are exempt. Nor does the

code provide an effective set of rules to preclude government procurement from imposing any kind of price preference or absolute preference for domestic goods (such as domestic content rules) over and above the preference accorded by the protective tariff. The agreement does not deal with governments' purchases of goods for resale, but only with purchases for their own use.

There was a marked increase, even while the GATT negotiations were proceeding, in U.S. procurement protection measures in Congress and at the state level. Commenting on the growing tendency in the United States to more protectionist pressures, Mr. Ron McCallum of Hawker Siddeley, Canada, told the Committee:

"Every new restrictive U.S. measure, be it legislative or procedural, appears to be regarded as a new negotiating base to determine what concessions are required on our side to recover some of the status quo on any particular issue." (11:11)

The Surface Transportation Assistance Act has seriously affected some Canadian producers, particularly in the urban mass transit industry. Mr. Kirk Foley, President of the Urban Transportation Development Corporation (UTDC) of Ontario, told the Committee that this industry has "no customers other than governments anywhere in the world", and that the average bid size in a project was from \$50 million to \$150 million and more if a whole transit system were involved. In the face of the restrictions under the Surface Transportation Assistance Act and at the state level, there is, as the Committee heard from Bombardier Inc. and other witnesses, a strong incentive for Canadian producers to establish facilities in the United States.

Mr. Grey pointed out that U.S. procurement rules are not always in the best interest of the United States and of U.S. component suppliers who sell to Canadian producers. For example, Canadian manufacturers of urban transit cars are heavy users of U.S.-made components, yet when these components re-enter the United States in finished Canadian exports, these components are not counted as U.S. content for procurement purposes. For tariff purposes, however, they are allowed duty-free re-entry as U.S.-made components. This can lead to a situation **where a French, German or Japanese firm which has established assembly facilities in the United States, using many components from their own countries, would be able to meet the U.S. preference list, whereas a Canadian-produced vehicle with higher actual U.S. content, would not meet the content requirements because of its heavy use of imported U.S. components.** In the urban transit industry, most buses in Canada are at least 50 percent U.S. content. If there were no orders from Canadian producers, U.S. suppliers would be the first to suffer.

Other sectors of Canadian industry are also adversely affected by U.S. procurement laws and regulations. In an earlier set of hearings, companies such as Northern Telecom, Wajax and ATCO told the Committee how they

had set up facilities in the United States in order to gain access to U.S. procurement markets. In a survey of its membership, the Canadian Manufacturers Association found that U.S. procurement rules were considered to be an impediment to growth by a significant number of industrial sectors, among these the transportation equipment, electrical machinery, rubber, clothing and metal fabricating sectors. Mr. C.D. Reekie, president of CAE pointed to the loss of Canadian jobs involved when Canadian companies found it difficult to sell Canadian-made products to U.S. federal departments or sub-contractors of federal agencies because of the Buy American legislation. He also described the trade impediment involved in the federal set-aside provisions whereby the U.S. government sets aside 5 to 15 percent of its total contracts for small U.S. businesses, minority-owned businesses or businesses located in high unemployment areas. Once a product has been secured as a set-aside, said Mr. Reekie, it is always procured as a set-aside as long as there are two qualified U.S. bidders in the running.

In considering the policy alternatives open to Canada in dealing with this problem, it is clear that Canada cannot expect to gain much in further multilateral procurement negotiations. From the experience in the Tokyo Round, the major European countries and the Japanese will strongly resist multilateral negotiations concerning access to their procurement markets.

Mr. Kirk Foley of the UTCD proposed that Canada should try to expand its technology agreements, similar to the 1972 Jamieson-Volpe arrangement with U.S. agencies to provide access for products under technology programs similar to the waiver provided for the joint North American space program. The North American transit market could then be jointly exploited by producers in the two countries through joint research and development programs and bilateral offset arrangements. The integration of the North American market could be extended by joint ventures and cross-licensing arrangements with U.S. companies, he suggested.

Mr. Rodney Grey's proposal was that Canada should seek a bilateral deal on procurement with the United States along the lines of the 1938 Defence Production Sharing Arrangement, which exempted Canada from the Buy American Act and from U.S. tariffs for defence supplies and equipment. In his proposed procurement arrangement, however, Mr. Grey suggested that tariffs could be left as they were or addressed later as a separate issue relative to procurement; the important aspect would be the mutual elimination of non-tariff barriers.

(iii) Customs valuation

The GATT agreement on valuation will establish uniform rules to be applied by all governments in determining the value of imported goods for customs purposes, based on the 'transaction value' of the goods. Mr. Grey

considers that the decision by Canada to adopt the new GATT agreement on customs valuation "will be the most important and most troublesome change in the Canadian commercial policy system" resulting from the Tokyo Round. The adherence and adjustment to the new system by the United States will also cause problems for Canada.

Canada agreed to the GATT Customs Valuation Code with great reluctance. Because more adjustments will be required by Canada than any other major trading country, Canada insisted on a reservation qualifying its agreement. It will bring its valuation system into conformity with the code on the understanding that it will be free to raise its tariffs to offset any significant loss of protection that might result. Canada is still negotiating such understandings bilaterally with its trading partners. The United States has agreed to this condition. In addition, Canada will not adopt the new code until 1 January 1985.

The new valuation system will require drastic changes in Canada's current 'fair market system' of valuation. Under the 'fair market value'* system, duty is based on the value at which goods are sold at arm's length by the exporter in his domestic market. The fair market value must not be less than the selling price to the Canadian purchasers exclusive of all charges on the goods after they leave the point of direct shipment to Canada, for example, ocean freight or insurance. The system, like that in the United States, has offered domestic producers an added measure of protection by frequently valuing goods at prices higher than those actually paid.

Under the new GATT 'transaction' system, valuation of goods will be based on the value at which goods move in international trade. Normally, this will be the selling price to the importer in Canada as long as the exporter and importer are dealing at arm's length. Extensive research is being undertaken by the Canadian government to determine the extent of the decline in protection resulting from adoption of the GATT system. In addition, as detailed in the section above on Canadian industrial strategy, the government has proposed, in its discussion paper on Import Policy, certain contingency protective procedures which could be put in place in order to deal with unexpected injury from lower protection.

Mr. Grey has warned that Canada will have certain problems with the United States as a result of the United States switching to the new system. While the new system will present fewer internal U.S. administrative difficulties than the nine different systems it had when the Tokyo Round began,

* This valuation basis uses the price charged in the home market of the exporter. The 'transaction value' system differs in that it sets the value for duty on the basis of the market conditions in the import market that is, usually, the selling price to the importer in Canada if the exporter and importer are at arm's length.

it could well open the way for harassment of legitimate import trade by resort to excessive administrative discretion or detailed enquiries if a domestic producer complains.

Furthermore, under what was called 'the old value law,' the United States had a Final List of about 1000 products on which significantly higher duty was retained by valuation on the basis of its export or foreign value, whichever was higher. This list adversely affected Canadian exports. The United States also had a protective device for benzenoid chemicals, called the American Selling Price (ASP) system of valuation. In abandoning the Final List and the ASP at the Tokyo Round, the United States secured agreement to a revised schedule of ad valorem rates for the products covered by the two systems. As a result, the level of protection will not be reduced. In fact for some products it will even be increased. For example, Mr. Clifford Mort of Dow Chemical of Canada, told the Committee:

"As a direct result of the U.S. switching from specific and ad valorem tariffs to ad valorem tariffs only, as part of the Tokyo Round of negotiations, together with the base that was used for establishing the ad valorem tariffs, the absolute level of tariffs for most major petrochemicals by 1985 will be higher than the tariffs that would have existed had the Tokyo Round of negotiations not taken place." (9:10)

Another important problem arising from the GATT valuation code which Mr. Grey has pointed to concerns Canadian import transactions not at arm's length, but between related companies. A large amount of Canada-U.S. trade is between Canadian subsidiaries and the U.S. parent, and the temptation to charge artificially low transfer prices for duty valuation purposes is great. The code deals inadequately with this problem, and with other categories of imports frequently found in bilateral trade with the United States, such as end-of-line, used capital equipment, seconds, etc.

(iv) DISC

Another non-tariff barrier not settled by the GATT codes is the U.S. export subsidization device DISC. The Domestic International Sales Corporation has been used by the United States since 1971 to stimulate exports and retain direct investment in the United States. It is not easy to assess the impact of DISC on Canadian investment levels or on Canadian exports. Canadian corporation taxes have been adjusted somewhat in compensation and nine out of ten Canadian companies surveyed by the Canadian Manufacturers Association said they were not affected by DISC.

Because of a proviso in the GATT agreement to the effect that any signatory country was only required to make a "reasonable effort" to overcome an obstacle such as Congressional resistance, the United States will be unlikely to dismantle DISC in the near future, even though such a scheme was clearly prohibited by the Tokyo Round. Moreover, because the Reagan

Administration wishes to challenge European Community officials on their tax-based subsidies, it appears to be hardening the U.S. position and will force a full scale GATT council procedure. The Committee sees the DISC as an area where Canadian interests are inadvertently affected when they are not the target. While DISC is not a major bilateral irritant it should not be overlooked.

c) Conclusion

While not wishing to diminish the accomplishments of the Tokyo Round, the Committee agrees with Mr. Grey that "there is a lot of unfinished business", which will leave a legacy of bilateral trading problems for the 1980s and 1990s in respect to both tariff and non-tariff problems. In particular, countervail and procurement problems may well prove critical for Canadian high technology producers. The risk of encountering these U.S. non-tariff barriers has a direct impact on whether these Canadian producers decide to locate their production facilities in Canada or the United States. There is an urgent need for Canada to resolve these issues.

APPENDIX B

Government Industrial Development Policies

In recent years, certain policies designed to stimulate necessary restructuring of Canadian manufacturing industry and to increase Canadian competitiveness have been implemented by the Canadian government. The attempt has been made to gain a larger market for Canadian products by import displacement programs; by industry development policies; by co-ordination of government procurement; by the use of FIRA; and by stimulating research and innovation, especially in high technology areas.

Import displacement

A growing emphasis in government policy is being put on trying to displace imports. The value of end product imports reached \$45 billion in 1981, over \$35 billion of which was from the United States. Various pronouncements and publicity drives have been aimed at encouraging the private sector to 'Shop Canadian.' The Department of Industry, Trade and Commerce has an import analysis unit which surveys customs data in an attempt to pinpoint products imported in sizeable quantities which might constitute an area for new Canadian industrial development. In 1980, the message to 'Shop Canadian' was spelled out more explicitly in the National Energy Program, which urged the domestic sourcing, wherever possible, of the equipment, technology and engineering requirements of the major resource-based megaprojects coming onstream. In August 1981, in order to monitor the sourcing of such purchases in megaprojects costing \$100 million or more, the govern-

ment established a new office in the Department of Industry, Trade and Commerce to ensure that Canadian companies had "timely access to full information on project requirements and early participation in the bidding process." Under this program, co-operation in trying to find Canadian suppliers will be mandatory for the oil and gas projects, but voluntary elsewhere in the economy. The objective of this program is to reduce the enormous Canadian deficit in bilateral machinery and equipment trade with the United States which, it is estimated, will amount in 1981 to \$14 billion; up from \$6.4 billion in 1976. Changes are also being made in Canadian import policy, and the 1980 government discussion paper on import policy contains several controversial proposals respecting emergency import safeguards and a possible 'basic price system' to cope with large-scale dumping problems. These proposals have not yet been acted upon.

Industry development

A keystone of the present industrial development policy is a program which has come to be known as 'picking winners.' Because standard technology industries are increasingly threatened by competition of low-cost imports from newly-industrialized countries (NIC's), the concern is that Canadian industry should move aggressively into high technology areas and areas where Canada has a comparative advantage. During 1980 and 1981 an industry development policy was planned with a proposed budget of \$2.75 billion (\$1 billion of which has already been budgeted) but the November 1981 budget transformed these plans of massive economic intervention to a more modest development strategy. The government is actively promoting a videotex system (Telidon) which it helped nurture, and through various programs, i.e., the Special Electronics Program, the Canadian Space Program, an office communications program, etc., it has sought to stimulate innovation and development in new areas of high technology which would allow Canadian firms to compete with innovative products in world markets. It has announced it will establish six micro-electronic centres across the country. Other sectors which have been mentioned as the focus of the government's high technology policy are aerospace, telecommunications, biotechnology, data processing, electronics, nuclear generation and urban transit.

Hand in hand with the 'picking winners' strategy has been the relaunching of the Defence Industry Productivity (DIP) program* and the Enterprise Development Program (EDP). The original objective of the DIP program is "to develop and sustain the technological capability of the defence industry for the purpose of generating economically viable defence exports and related civil exports arising from that capability". Much of the assistance it provides

* Because of budgetary restraint and an evaluation study, the DIP program was stopped for 1½ years and was re-opened in 1981.

is designed to assist in expensive innovative R&D necessary for successful exporting. DIP funding was increased by 100 percent during 1981. As an example of this type of financing, grants of \$50 million have gone to Pratt and Whitney for a new turbine engine, the PT-7, and \$450 million to de Havilland for development of another commuter aircraft, the DASH-8.

The EDP, established in 1977, encompasses seven earlier programs including the Program for Advancement of Industrial Technology (PAIT). The purpose of EDP is to supplement the financial resources of small and medium sized manufacturing and processing industries in undertaking higher risk projects which might otherwise be left dormant. Under this program, grants for the research, development and even production and marketing of new products are possible and loan guarantees are also available. EDP approvals for grants have risen rapidly from \$18 million for 1977-78 to \$84 million for 1979-80 and loan guarantees have doubled.

Both these programs have as a primary objective the stimulating of innovative industrial R&D. In January 1981 the government made a new commitment promising to raise Canada's R&D expenditures to the equivalent of 1.5 percent of GNP, from the present level of about 1 percent, by 1985. Three years earlier, the government had announced it would reach this same target by 1983, but results had made the goal unrealistic.

All in all, the federal research and development expenditures, exclusive of tax incentives, will be almost \$1.5 billion in the 1981 fiscal year. In addition, the government provides tax incentives allowing 100 percent write-offs for R&D spending and the possibility of qualifying for a supplemental 50 percent deduction on incremental R&D. A 10 percent investment tax credit for R&D is also available.

As announced at the time of the November 1981 budget, the government will draw together its existing programs for industrial innovation under a co-ordinating Industrial Opportunities Program Board. This program is designed to provide assistance for restructuring, as well as support for all phases of the product innovation cycle including initial R&D, product and process design and innovation, prototype development, organizational change, market identification and testing.

Strengthening FIRA

In order to deal with what were perceived to be constraints on Canadian industrial development due to the high degree of foreign ownership of Canadian industry, the government announced in the 1980 Throne Speech its intention of strengthening the workings of the Foreign Investment Review Agency (FIRA), including performance reviews of how existing large foreign-owned firms in Canada were meeting the requirements of the legisla-

tion; publication of foreign takeovers before they were approved so Canadian firms could bid; and federal assistance for such counter-bids. Although no new legislation was introduced, a more stringent enforcement of the existing legislation was noticeable in 1981, with an apparent stronger emphasis on "the significant benefit to Canada" which a foreign firm must be prepared to make and a firmer commitment to performing R&D in Canada, to Canadian equity participation and to product mandating. However in the budget speech in November 1981, the government withdrew from its earlier commitment and announced it had decided not to amend the Foreign Investment Review Act for the time being. The Finance Minister said Ottawa would not extend Canadian ownership targets, as implemented in 1980 for the oil and gas industry, to other sectors. No legislative action on buy-back and pre-notification measures was planned. Mandatory performance review and reporting mechanisms for larger corporations were not proposed. An assessment of the administrative procedures is being undertaken, however, to establish what changes in procedure might be warranted.

Procurement

The Canadian government has long employed certain preferences for Canadian goods. More recently it has been attempting to co-ordinate government procurement as another instrument in the restructuring of the Canadian manufacturing industry. At the federal level, a planning system now exists so that the major 'buying' departments, when purchasing goods or services valued at over \$2 million, will source their purchases in a way which will best support domestic economic development objectives. This process is in addition to the government's policy of requiring industrial benefits and offsets, such as for the new fighter aircraft or the long-range patrol aircraft. Certain federal initiatives have also been taken to try to co-ordinate the buying of provincial governments, to which the government of Ontario in particular has given support.

In 1979, a product development fund of \$115 million was created to help companies enter new fields and make products, particularly in high technology areas, which the government wants to buy. The federal Department of Supply and Services, which accounts for about 25 percent of purchasing by all levels of governments, has a Procurement Review Committee which looks at every federal government purchase of more than \$2 million in terms of maximizing Canadian purchases. A Source Development Fund of \$30 million was established in 1981 to pay the difference between a Canadian company's higher bid and a foreign bid in certain cases, over the next three years.

Competition policy

The government's competition policy, particularly the extent to which it might inhibit the rationalization of industry, is of direct interest to Canadian

manufacturing firms. This policy is still in its formative stage, awaiting the introduction to Parliament of a new competition bill in 1982.

Other measures

The government has doubled the budget for export market promotion and provided \$900 million to the Export Development Corporation over the next three years to enable it to provide export financing at more favourable rates, but Canada may still be well behind the heavily subsidized rates of many other countries, a fact which appears to be hurting Canadian exporters badly, particularly in markets other than the United States where the dollar is over-valued. In 1979, the federal government put \$235 million in a joint federal-provincial program to help strengthen and modernize the Canadian forest products industry. In support of provincial governments seeking to influence the investment decisions of multinational auto manufacturers, the federal government has assisted with large grants to ensure new investment is located in Canada. In addition, refinancing assistance has been provided to both the Chrysler Corporation of Canada and Massey-Ferguson, which were and remain in difficulties.

In January 1981, a special industrial and labour adjustment fund of \$350 million was announced, which over the next three years will help displaced workers and assist communities which are particularly hard hit by industrial readjustment. In June 1981, the government allocated \$250 million over 5 years to establish new employment opportunities in communities affected by restructuring in the textile and clothing industry and to assist in the modernization of viable firms.

APPENDIX C

Canada-U.S. Competitiveness

Relative labour costs

The Committee's 1978 report expressed concern over the serious deterioration in Canadian competitiveness vis-à-vis the United States. One of the major elements in Canadian lack of competitiveness, which was emphasized by almost all the business witnesses, was the higher increases in Canadian wage rates relative to the wage settlements in comparable U.S. industries—a trend which was closing the traditional gap between Canadian and American labour costs.

During the more recent hearings, Dr. James Frank of the Conference Board in Canada told the Committee that his study of 84 matching Canadian and U.S. industries revealed that not only was the wage gap being closed, but in many industries there was a gap in the other direction. In 55 out of 84 industries studied, Canadian production workers were being paid as much or more than their U.S. counterparts by 1975. In response to concern at this accelerating rate of wage increases, the Canadian wage control program was introduced in 1975, a development which modified the trend for several years. Some resulting improvement was noted by the Conference Board study which showed that by 1978 those industries in which Canadian earnings equalled or exceeded U.S. earnings had dropped to 48 out of the 84 studied. But Dr. Frank emphasized that the decline in the number of Canadian industries at or above wage parity with comparable U.S. industries was not a

reversal of a long run trend which was leading to wage parity. Rather, it was the result of the Canadian dollar devaluation. If the devaluation of the Canadian dollar had not occurred, these Canadian labour costs would still stand at considerably higher levels than comparable U.S. costs.

In respect to differences in the average manufacturing wages in the two countries, data supplied by Professor Wonnacott confirmed the impact of the exchange rate. When the relative level of earnings is examined on an exchange rate adjusted basis, Canadian earnings in manufacturing had declined by 1979 to a level of about 95 percent of the U.S. rate, down from a high of \$1.12 in 1976 and \$1.06 in 1977 (See Table 3, column 4).

Table 3

Canada/U.S. Wage/Productivity/Exchange Rate Nexus, 1968-1978

Canada-U.S. Labour Cost Comparisons:						
	Exchange rate (Value of Canadian to U.S. dollar) (1)	Hourly Manufacturing Wages (in Canadian dollars) Canada (2) United States (3)		Relative Wages (Can./U.S.) (4)	Relative Total Compensation (Can./U.S.) (5)	Productivity Comparison (Can./U.S.) (6)
1968	92.8	2.58	3.24	.80	.77	.65
1969	92.9	2.79	3.44	.81	.78	
1970	95.6	3.01	3.51	.86	.81	
1971	99.0	3.28	3.61	.91	.86	
1972	101.0	3.54	3.78	.94	.88	.73
1973	100.0	3.85	4.08	.94	.88	.75
1974	102.2	4.37	4.32	1.01	.94	.80
1975	98.4	5.06	4.91	1.03	.95	.74
1976	101.4	5.76	5.15	1.12	1.03	.75
1977	94.1	6.38	6.04	1.06	.98	.76
1978	87.7	6.84	7.04	.97	.90	.78
1979	85.4	7.43	7.83	.95	.88	—
1980	85.5	—	—	.97	—	—

Sources: Professor J. Wonnacott (18A:1), and additional updated figures from J. Frank, Conference Board in Canada.

Even this comparative wage advantage due to the exchange rate is being eroded. Statistics in 1979 and 1980 indicate that Canadian wage settlements are again rising faster than U.S. rates. In the manufacturing sector for example, Canadian wage rates increased by 8.8 percent and 10.1 percent in 1979 and 1980 compared to 8.5 percent and 8.7 percent respectively, in the United

States. Mr. Frank voiced his concern to the Committee that Canadian industries, after having had the benefits of significant devaluation, will again come under pressure on the competitive front in the next several years.

The situation looks only slightly more promising when total compensation, that is, earnings plus social security benefits, are calculated on an exchange rate adjusted basis. U.S. benefit costs themselves are actually higher, averaging 21.2 percent of pay, for time worked and not worked, compared to 11.2 percent in Canada. When this considerable differential is added to wages in the manufacturing sector, Mr. Frank said, Canadian earnings plus benefits were approximately 88 percent of U.S. levels in 1979, an improvement from the 95 percent figure when earnings alone are considered. But even with this gap, Canadian labour costs would still have been 2 percent higher than in the United States had the Canadian dollar not been devalued.

The higher Canadian labour costs were commented on frequently by business witnesses before the Committee. For instance, Mr. Ron McCallum of Hawker Siddeley, Canada, said that the labour cost and productivity differential was particularly severe in their British Columbia operations where his company faced 35 percent higher labour costs in "virtually identical operations" than those available across the border. Mr. John Sandford, president of de Havilland Aircraft of Canada said his company pays from \$2 to \$3.50 an hour more than competing U.S. aircraft manufacturers. It was only the lower Canadian dollar which allowed his firm to compete successfully he said.

Work stoppages

Another factor which is frequently cited as a reason for Canada's poor competitive performance is that of work stoppages. Table 4 indicates that Canada, in 1978, had a significantly worse record in this regard than did the United States, with 840 working days lost per thousand employees in Canada, compared to 438 in the United States. In only two years since 1970 has Canada not had more days lost per thousand employees due to industrial disputes than the United States.

Relative Canada-U.S. productivity*

Canadian industry has traditionally had a significantly lower productivity level than U.S. industry, another factor affecting its weaker competitive position. (See Table 3, column 6.) This historic productivity gap between Canada and the United States has narrowed somewhat particularly in the manufacturing sector, thanks to a somewhat faster overall rate of produc-

* It should be noted that labour productivity not only reflects the output per man per hour but the range of skills and capital equipment the average worker has to work with.

Table 4

Work stoppages and time lost due to industrial disputes, 1955-79

Country and year	Number of industrial disputes	Workers involved (thousands)	Working days lost (thousands)	Days lost per thousand employees
UNITED STATES				
1970	5,716	3,305	66,414	956
1971	5,138	3,280	47,589	661
1972	5,010	1,714	27,066	374
1973	5,353	2,251	27,948	373
1974	6,074	2,778	47,991	629
1975	5,031	1,746	31,237	415
1976	5,648	2,420	37,859	485
1977	5,056	2,040	35,822	443
1978	4,230	1,624	36,923	438
1979	4,800	1,700	33,000	381
CANADA				
1970	542	262	6,540	970
1971	569	240	2,867	414
1972	598	706	7,754	1,075
1973	724	348	5,776	754
1974	1,218	581	9,222	1,131
1975	1,171	506	10,909	1,313
1976	1,039	1,571	11,610	1,388
1977	803	218	3,308	387
1978	1,058	402	7,393	840

Source: *Handbook of Labor Statistics*, U.S.A., December 1980, Table 186, p. 478.

tivity growth in Canada in recent years. From 1947 to 1978, Mr. Frank told the Committee, Canada had a bigger improvement in its average labour productivity in the manufacturing sector (4.1 percent) than did the United States (2.7 percent). From 1971 to 1979 productivity growth in both countries slowed considerably, but Canada's 2.9 percent productivity growth was still slightly better than the 2.1 percent rate in the United States, particularly from 1976 to 1978.

From an intensive study by the Conference Board, which looked at relative Canada-U.S. productivity levels in 33 matched manufacturing industries between 1967 and 1974, Mr. Frank told the Committee that Canadian labour productivity had increased on average from 62 percent of U.S. levels to 77 percent. Gains were most pronounced for the durable goods industries such as wood products, metal products and motor vehicles and parts. By 1974 the durable goods sector was found to be 94 percent as productive as compa-

table U.S. industries. Certain sectors showed significant performance. The wood products industries for example were estimated to have a productivity level of 117 percent of the U.S. level and motor vehicles and parts were 100 percent of the U.S. rate. However, for the non-durable goods sector the level was only 68 percent of U.S. counterparts for 1974, although there was a marked improvement over the 1967 rate of 53 percent, particularly in petroleum products. Mr. Frank estimated the relative levels in these industries would not have changed significantly by 1979. (See Table 5). The Committee notes with interest that the improved productivity levels occurred in those industries which enjoyed free or almost free access to the larger U.S. market for their products.

Table 5

**Estimated Relative Productivity Levels (Canada/United States)
Percentage 1967 and 1974 Major Industry Groups**

	1967	1974
<u>Nondurable Goods</u>	<u>53%</u>	<u>68%</u>
Food Processing	72	69
Textiles, Clothing, Knitting	70	83
Paper Products	76	77
Petroleum Products	37	70
Miscellaneous	44	53
<u>Durable Goods</u>	<u>73%</u>	<u>94%</u>
Wood Products	111	117
Metal Products	70	93
Motor Vehicles & Parts	77	100
Miscellaneous	60	68
TOTAL SAMPLE	62%	77%

Source: J.D. Frank (1979, 2:25)

It is generally agreed by business witnesses and academics alike that the greatest single reason for the lower Canadian productivity is the shorter runs and lack of specialization in production, arising from a smaller protected market with the same wide tastes as Americans. Canadian producers, responding to the protective tariffs in Canada and elsewhere as well as the non-tariff barrier obstacles have, in the past, geared their production for the Canadian market. This has caused frequent labour and machine changes resulting in higher labour costs and lower productivity. Lowering tariffs and rising costs have forced some specialization and Canadian productivity has grown somewhat faster than in the United States in recent years. However, a

substantial Canada-U.S. productivity differential still remains, estimated at 22 percent in 1978. (See Table 3, column 6). Furthermore, forecasts for future Canadian productivity growth are generally pessimistic. For many Canadian manufacturing firms, the key to whether they will survive the increased competitive pressures of the 1980s and 1990s will depend on increases in their productivity levels.

Comparative unit labour costs

With lower productivity in Canada than the United States, the relatively high Canadian wage rates continue to put upward pressure on Canada's unit labour costs, thereby lowering Canadian competitiveness.

According to Dr. Frank, Canada's unit labour costs, based on the relationship between productivity growth and increases in wage rates, increased consistently throughout the 1970s at a faster rate than those in the United States until 1978, rising particularly more quickly in 1975 and 1976. In 1978 mainly because of the slowing of the Canadian wage increases noted earlier, the Canadian unit labour costs increased less quickly than those in the United States. (See Table 6 below). Unfortunately it is becoming increasingly evident that the trend to higher Canadian unit labour costs has reasserted itself in 1979, 1980 and 1981 although comparable figures are not yet available.

Table 6

Unit Labour Costs (U.S. dollar basis) Index 1967=100.

	Canada	U.S.
1967	100.0	100.0
1970	111.7	116.5
1973	126.2	123.2
1974	146.2	143.1
1975	165.6	152.4
1976	185.7	158.2
1977	182.5	166.6
1978	174.3	179.4

Source: Table 179, p. 467 *Handbook of Labor Statistics*, U.S.A., December 1980.

Overview of current Canadian competitiveness

There have been certain modifications in the comparative cost structures in Canada and the United States during the three years since the Committee's earlier comments. The dramatic deterioration of the mid-70s has been arrested. Nonetheless the overall competitive disadvantage of Canadian industry remains. Average Canadian wage rates now stand, at the

exchange rate adjusted basis, at approximately 95 percent of the U.S., but observers fear that the benefit of the exchange rate change is being eroded by recent high Canadian wage settlements. There have been modest gains in Canada's productivity levels relative to the United States, although both countries performed badly in comparison to Japan. The Canadian durable goods sector particularly showed considerable gains in this respect, but even so, average Canadian productivity is still estimated at only about 78 percent of the U.S. level. Work stoppages in Canada also continued to be higher than in the United States, with one exceptional year.

APPENDIX D

Glossary of Terms

Balance of payments is the financial summary of all the transactions between Canadians and people in other countries. It is divided into two sections:

1. **Current account**, which is, in turn the sum of:
 - (a) the balance of the receipts from Canada's merchandise exports and the payments for its merchandise imports. The difference between these determines whether Canada has a surplus or a deficit in its merchandise trade account. (This is the figure most often quoted on a monthly basis and is usually in Canada's favour).
 - (b) the balance of non-merchandise transactions. This is frequently called trade in 'invisibles' or trade in services. It includes receipts and payments for such things as travel, interest and dividends, royalties, patents, copyrights, freight and shipping charges, banking and insurance etc. (Canada always runs a deficit on non-merchandise trade.)

Current account is the sum of (a) and (b) above and when these are taken together, Canada suffers from a serious ongoing balance of payments deficit on its current account.

2. **Capital account** which reflects the movement of capital in and out of Canada, including direct investments, portfolio investments, bank term deposits, foreign aid, export credit financing, etc.

Countervail is a duty imposed by one country to offset the lower price of an imported good, production of which has been subsidized by the producer's government.

DIP The Defence Industry Productivity program is a federal program designed to provide funding to assist Canada's high technology defence-related industries to be competitive in international terms.

DISC Domestic International Sales Corporation is an export subsidization device set up in 1971 by the United States to promote exports by deferring taxes on a firm's income derived from exports. It has the second effect of influencing the locational decisions of U.S. multinationals in favour of production for export in their U.S.-based plants as opposed to their foreign subsidiary.

EC or EEC The European Community or the European Economic Community is a common market arrangement established in 1957 under the Treaty of Rome by six founding countries in Western Europe—Belgium, France, Luxembourg, the Netherlands, Italy and West Germany. In 1973, it was expanded to include Denmark, Ireland and the United Kingdom. Greece became a member in 1981 and Spain and Portugal are scheduled to join. A common external tariff is levied on all dutiable imports from outside the EC and a Common Agricultural Policy is applied. A broad objective of economic and political integration has been enunciated. Co-operation already exists on industrial, scientific, competition and regional development policies and varying degrees of EC policy co-ordination exist in international economic matters, in monetary arrangements and in foreign policy.

Economies of scale involve the increased efficiency and reduced production costs which are achieved by increasing the volume of production of a given product, a process as possible in a small plant as in a large plant if the market is large enough.

EDP, The Enterprise Development Program is a federal government grant program to support innovative manufacturing in Canada. Replacing seven earlier programs, the EDP channels most of its grants to small and medium businesses providing funding assistance for the research, development, production process or marketing of an innovative product line.

EFTA The European Free Trade Association is a free trade area established by seven European nations in 1959 under the Stockholm Agreement as an alternative to the European Community. Its members were Austria, Denmark, Norway, Portugal, Sweden, Switzerland and the United Kingdom with Finland and Iceland subsequently joining. No common external tariff was established nor was there any move by EFTA members to move toward inte-

gration of their economies. This was a classic free trade area as opposed to a common market or customs union. After Denmark and the United Kingdom left EFTA to join the European Community, all the remaining members, i.e. Norway, Sweden, Finland, Iceland, Austria, Switzerland and Portugal entered into individual free trade agreements with the EC.

FIRA The Foreign Investment Review Act or the Foreign Investment Review Agency. Legislation passed in 1973 established the agency to screen foreign takeovers and, later, new foreign investment in Canada. The task of the agency is not to block foreign investment but to negotiate with foreign firms to ensure that a significant benefit to Canada will result from their investment decisions.

GATT The General Agreement on Tariffs and Trade is an international agreement signed in 1947, initially by 23 Contracting Parties, including Canada. Its objectives include the gradual reduction of trade barriers, the promotion of international trade on a non-discriminatory basis and the prevention of a return to the protectionist and discriminatory policies of the 1930s. A secretariat in Geneva monitors trade practices and can establish panels to rule on trade disputes between GATT signators.

MTNs or Multilateral Trade Negotiations are the series of trade talks held under the auspices of the GATT from time to time. As the opening meeting of the most recent round of negotiations took place in Tokyo, this series became known as the Tokyo Round, to distinguish it from earlier negotiations such as the Kennedy Round or the Dillon Round.

NEP National Energy Program is the federal government's energy measures, the objectives of which were set out in the 1980 Budget speech.

NICs are newly industrialized countries, a term used to describe less developed countries which are industrializing rapidly. Examples of NICs include the 'New Japans' as they are frequently called such as Korea, Taiwan or Hong Kong.

Non-tariff barriers (NTBs) are government policies which make it more difficult for imports to enter a country. Clear examples of non-tariff barriers are government procurement rules favouring domestic producers; subsidies which increase the competitiveness of domestic producers; technical standards which may be written to accommodate domestic producers and to make it difficult for foreign producers. But more obscure examples are almost endless from a local government's arbitrary mark-up of foreign wine to contrived technical delays at customs.

PAIT, the Program for the Advancement of Industrial Technology was a federal government assistance program to promote new and innovative tech-

nology in Canadian industry. The program was incorporated into the more comprehensive EDP program in 1977.

Productivity refers generally to 'total factor productivity' which encompasses the use of all the factors involved in production such as capital, buildings, equipment, technology, process, workers' skills, management's skills, etc. Productivity levels are **not**, as is often assumed, a reflection of how hard an individual worker works.

Terms of trade is the ratio of the price index for merchandise exports to the price index for merchandise imports. A country's terms of trade improve if prices for its exports rise higher than for its imports.

Tokyo Round See MTNs.

Trade classifications are technical categories used by Statistics Canada in classifying exports and imports. They include crude materials, fabricated materials and end products.

Crude materials—refers to raw unprocessed products such as coal or iron ore.

Fabricated materials—refers to crude materials or other commodities which have been processed but are not yet an end product. Examples are finished lumber, newsprint or aluminum ingot.

End products—refers to fully manufactured products which are ready for use by the consumer or in the assembly of another end product.

Manufactured goods is a widely used term which includes both end products and a large number of fabricated materials. However manufactured goods is not a category for which specific statistics are kept in Canada.

World product-mandating is the assignment by a multinational company to a subsidiary firm of the responsibility for the manufacturing and marketing of a given product on an international basis.

APPENDIX E

Witnesses

1. List of witnesses who appeared before the Committee, showing the number and date of the issue in which their evidence appears.

First Session of the Thirty-first Parliament, 1979

Issue No.	Date	Witnesses
2	December 11, 1979	<i>Conference Board in Canada</i> Dr. James Frank, Director, Compensation Research Centre <i>Economic Council of Canada</i> Dr. D.W. Slater, Director

First Session of the Thirty-second Parliament, 1980-82

Issue No.	Date	Witnesses
1	May 6, 1980	Dr. David A. Dodge, Director, Institute for Research on Public Policy

- | | | |
|---|---------------|---|
| 2 | May 15, 1980 | Professor Peyton V. Lyon, School of International Affairs, Carleton University |
| 3 | June 3, 1980 | Professor John J. Quinn, Faculty of Law, University of Western Ontario, London, Ontario; and Director, Canada-U.S. Law Institute |
| 4 | June 5, 1980 | Mr. Rodney de C. Grey, Advisor to the Government of Ontario, London, England; formerly Head of the Canadian Delegation to the Tokyo Round of the GATT multilateral trade negotiations. |
| 5 | June 10, 1980 | The Hon. Robert L. Stanfield, P.C., Q.C. Mr. Harold Connor, Halifax, N.S. Mr. James McNiven, Executive Vice-President, Atlantic Provinces Economic Council |
| 6 | June 12, 1980 | <i>Department of Industry, Trade and Commerce</i>
Mr. Robert Johnstone, Deputy Minister
Mr. R.E. Latimer, Assistant Deputy Minister, International Trade Relations |
| 7 | June 25, 1980 | Mr. Julius Katz, Senior Vice President, White Plains, N.Y., U.S.A.; formerly Assistant Secretary of State for Economic and Business Affairs, Department of State, Washington, D.C.
<i>Brookings Institute</i>
Mr. Lawrence Krause, Senior Fellow, Washington, D.C., U.S.A. |
| 8 | June 26, 1980 | <i>Canadian Furniture Industry</i>
Mr. K.M. Campbell, General Manager, Ontario Furniture Manufacturers' Association
Mr. Gerry Cockerill, Vice-president and General Manager, Kaufman Company, Collingwood, Ontario
Mr. Claude Jutras, General Manager, Quebec Furniture Manufacturers' Association Inc.
Mr. Bruce MacPherson, President, Gibbard Furniture Shops Ltd., Napanee, Ontario
Mr. Joe Malko, Furniture West Inc., Winnipeg, Manitoba |

- Mr. Bernard Papineau, President, H.P.L. Cie, Arthabaska, Quebec
 Mr. Norman Ricard, President and General Manager, NORCA Management Ltd., Montreal, Quebec
- 9 July 8, 1980 *Canadian Petrochemical Industry*
 Mr. R.L. Pierce, President, Alberta Gas Ethylene Company, Calgary, Alberta
 Mr. Clifford L. Mort, Chairman, Dow Chemical of Canada Co., Sarnia, Ontario
 Mr. B.G.S. Withers, Vice President, Corporate Operations, Petrosar, Corunna, Ontario
 Mr. Jack S. Dewar, President, Union Carbide Canada Ltd., Toronto, Ontario
- 10 July 10, 1980 *Canadian Institute for Economic Policy*
 Dr. Abrham Rotstein, Vice-Chairman
 Dr. Fred Lazar, Director
- 11 October 16, 1980 *Urban Transportation Industry*
 Mr. Raymond Royer, President and General Manager, Mass Transit Division, Bombardier Inc., Boucherville, Quebec
 Mr. Ron McCallum, Corporate Director of Marketing, Hawker Siddeley Canada Inc., Toronto, Ontario
 Mr. Kirk W. Foley, President, Urban Transportation Development Corp. Ltd., Toronto, Ontario
- 12 October 30, 1980 Mr. David Mundy, Carp, Ontario
 Mr. John Simons, Vice-President, Avionics Division, Canadian Marconi Company, Montreal, Quebec
- 13 November 13, 1980 *Aerospace Industry*
 Mr. John W. Sandford, President & Chief Executive Officer, de Havilland Aircraft of Canada, Limited, Downsview, Ontario
 Mr. E.L. Smith, President & Chief Executive Officer, Pratt & Whitney Aircraft of Canada Ltd., Longueuil, Quebec
 Mr. E.A. Reece, Vice-President & General Manager, McDonnell Douglas Canada Ltd., Toronto, Ontario

- 14 December 9, 1980 *Canadian Manufacturers' Association*
Mr. Jean-Jacques Gagnon, Senior Executive Vice-President, Aluminium Company of Canada, First Vice-president of CMA
Mr. L.R. Douglas, Vice-President, Canadian General Electric Co. Ltd., Chairman of the CMA Trade Policy Committee
Mr. Ron McCallum, Corporate Director of Marketing, Hawker Siddeley Canada Inc., Chairman of the CMA Export Committee
Mr. Laurent Thibault, Director of Economics and Communications for the CMA
- 15 December 11, 1980 *High Technology Industry*
Mr. Larry Clarke, Chairman and Chief Executive Officer, Spar Aerospace Limited, Toronto, Ontario
Mr. C.D. Reekie, President and Chief Executive Officer, CAE Industries Limited, Toronto, Ontario
Mr. W.C. Tate, Vice-President and General Manager, Garrett Manufacturing Company Limited, Rexdale, Ontario
Mr. Ronald R. Keating, President, Litton Systems Canada Limited, Rexdale, Ontario
- 16 January 20, 1981 Mr. F.H. Tyaack, President and Chief Executive Officer, Westinghouse Canada Inc., Hamilton, Ontario
Mr. M.J. McDonough, Senior Executive Vice-President, Corporate Resources, Westinghouse Inc., Pittsburgh, Pennsylvania, U.S.A.
- 17 January 22, 1981 Professor Sidney Weintraub, Dean Rusk Professor, Lyndon B. Johnson School of Public Affairs, University of Texas, Austin, Texas, U.S.A.
- 18 February 3, 1981 Professor Ronald J. Wonnacott, Department of Economics, University of Western Ontario, London, Ontario
- 19 March 3, 1981 *Department of Industry, Trade and Commerce*
Mr. B.C. Steers, Assistant Deputy Minister, International Marketing
Mr. Percy Eastham, Director General,

Office of General Relations
Mr. Norman Fraser, Acting Director General, Programs Branch
Mr. Craig Oliver, Senior Director General, Industry and Commerce Development

20 March 5, 1981

Province of British Columbia
The Honourable Patrick McGeer, Minister of Universities, Science and Communications

21 March 26, 1981

Province of Alberta
The Honourable Hugh Planche, Minister of Economic Development
Mr. E.G. (Ed) Shaske, Executive Director, Strategic Planning Branch, Department of Economic Development

22 April 7, 1981

Province of Ontario
The Honourable Larry Grossman, Minister of Industry and Tourism

2. Written Submissions

1. October 23, 1980 Mr. Ian C. Rush, President, Polysar Limited, Sarnia*
2. October 27, 1980 Mr. J.E. Newall, Chairman and Chief Executive Officer, Du Pont Canada Inc., Montreal.*
3. June 11, 1981 The Honourable Roland J. Thornhill, Minister of Development, Province of Nova Scotia, "Implications of Bilateral Free Trade for Nova Scotia".

Washington Study Trip, April 28th-30th, 1981

The purpose of the Washington study trip was to seek, at the conclusion of the Committee's formal hearings, the opinions of a selection of United States officials, academics, business and labour figures on the issues of Canadian-U.S. trade relations, investment and related bilateral problems. Of particular interest to the Committee was U.S. reaction to the idea of a bilateral free trade agreement. Spokesmen were in the following order:

1. *U.S. Chamber of Commerce, Committee on Canada-U.S. Relations:*

* These two earlier witnesses from the chemical sector who had testified at the 1977 hearings were asked to comment on or add to their earlier testimony in the light of the Committee's examination during 1980-81 of the impact of bilateral free trade with the United States and in view of the more recent testimony of other witnesses from the petrochemical sector.

Topic: Perspectives of U.S. corporate executives on aspects of the Canada-U.S. relationship including proposals for increased North American interdependence.

U.S. Participants:

Mr. William G. Phillips	Chairman of the Board International Multifoods Chairman, U.S. Section, Committee on Canada-United States Relations, Board of Directors Chamber of Commerce of the U.S.
Mr. George H. Fuchs	Executive Vice President Industrial Relations RCA Corporation
Mr. Earl Huntington	Vice President and General Counsel Texasgulf, Inc.
Mr. Clinton Morrison	Past Chairman, Board of Directors Chamber of Commerce of the U.S. Retired Vice Chairman, Now Consultant First National Bank of Minneapolis
Mr. J.R. Mullen	Vice President, Corporate Relations Johnson and Johnson
Mr. E. Leslie Peter	President Leslie Peter and Company
Dr. George W. Phillips ¹	Coordinator, International Trade Affairs Union Carbide Corporation
Mr. Dudley C. Taft	President Taft Broadcasting Company
Dr. Roger Frank Swanson	Executive Secretary, U.S. Section Committee on Canada-United States Relations
Dr. John Volpe	Director, International Research Chamber of Commerce of the U.S.

2. *U.S. officials on Canada-United States trade relations:*

Topic: Round table discussion on prospects for Canada-United States free trade or bilateral preferential trading arrangements with Canada.

¹ Dr. Phillips represented Mr. R.J. Hughes, Senior Vice President and was accompanied by Mr. James K. O'Connor, Economic Analyst and Staff Executive, International Trade Committee, North American Economic Interdependence Task Force, Chemical Manufacturers' Association.

U.S. Participants:

Mr. Ernie Johnson	Deputy Assistant Secretary for Economic and Business Affairs, Department of State
Mr. John Ray	Assistant Special Trade Representative
Mr. Bill Morris	Assistant Secretary of Commerce, Trade and Development

3. *Canadian-American Committee (National Planning Association):*

Topic: Discussion on the Committee's draft report: "A proposal for improving the intergovernmental process for dealing with Canadian-American economic issues".

U.S. Participants:

Mr. William D. Eberle	U.S. Report Chairman; formerly U.S. Special Trade Representative
Mr. Sperry Lea	Vice-President, National Planning Association

4. *Discussion with Mr. Fred Bergsten:*

Topic: Prospects for closer Canada-United States trade relations.

U.S. Participant:

Mr. Fred Bergsten	Senior Associate, Carnegie Endowment for International Peace, formerly. Assistant Secretary International Affairs, Department of the Treasury.
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5. *Discussion with officials from the Office of the Special Trade Representative:*

Topic: The U.S. Task Force Report as requested by Congress in the 1979 U.S. Trade Agreements Act.

U.S. Participants:

Mr. Harvey Bayle	Deputy Assistant U.S. Special Trade Representative for Policy Development
Mr. Andrew Stoler	STR Official with Specific Responsibility for Canada
Mr. William DesRochers	Department of Commerce

6. *Discussion with Professor Robert Dunn Jr.:*

Topic: The exchange rate and capital flow effects of a Canada-United States bilateral free trade arrangement.

U.S. Participant:

Professor Robert Dunn Jr.	Department of Economics, George Washington University
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7. *Discussions with U.S. Senate and House Staff Members:*

Topic: Closer Canada-United States trade relations, with particular focus on the possibility of a preferential bilateral trading arrangement.

U.S. Participants:

Mr. Ed Nef

Mr. Gary Horlick	Congressional staff
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Mr. George Ingram

8. *Discussions with U.S. Labour Leaders—AFL-CIO*

Topic: Canada-United States trade relations, with particular emphasis on a possible Canada-United States free trade arrangement.

U.S. Participants:

Mr. Thomas Donohue	Secretary Treasurer AFL-CIO
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Mr. Henry Schechter	Department of Economic Research AFL-CIO
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Mr. Stephen Coplan	Department of Legislation AFL-CIO
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Mr. Mark Anderson	International Department AFL-CIO
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9. *During luncheon, the Committee met the following members of the U.S. Senate:*

Senator Max Baucus	Montana, Democrat Co-Chairman, Senate Caucus Committee on North American Economic Interdependence
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Senator Spark Matsunaga	Hawaii, Democrat (Sponsor of provision exempting Canada and Mexico from U.S. Convention Tax Legislation in January 1981.)
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Senator Ted Stevens

Alaska, Republican
Deputy Majority Leader of the Senate, Co-
Chairman, U.S. Section, Canada-United
States Interparliamentary Group

Senator Ed Zorinsky

Nebraska, Democrat
former Co-Chairman, now Vice-Chairman,
U.S. Section, Canada-United States Inter-
parliamentary Group

